



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

**Date:** January 21, 2014  
**To:** All Approved Mortgagees  
**Mortgagee Letter 2014-02**

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**Subject** Manual Underwriting

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**Purpose** This Mortgagee Letter provides policy guidance for revised manual underwriting requirements published in Final Federal Register Notice FR-5595-N-01 on December 11, 2013 at <http://www.gpo.gov/fdsys/pkg/FR-2013-12-11/pdf/2013-29170.pdf>.

Based on the Final Notice, this Mortgagee Letter explains maximum qualifying ratios for manually underwritten loans, and revises and clarifies the compensating factors that must be cited in order to exceed FHA's standard qualifying ratios for manually underwritten loans.

This Mortgagee Letter also explains the new reserve requirement for manually underwritten loans for one and two unit properties.

This Mortgagee Letter is *not* applicable to:

- Non-credit qualifying FHA to FHA streamline refinance mortgages;
- Refinances of Borrowers in Negative Equity Positions (ADP Codes 821, 822, 831 832);
- Section 255 Home Equity Conversion Mortgages; or
- Title I loans.

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**Effective Date** This guidance is effective for case numbers assigned on or after April 21, 2014.

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## Mortgagee Letter 2014-02, Continued

**Affected Topics** The topics summarized below are affected by these changes in guidance. Below is a list of the blocks in the subject handbook that are affected. The changes will be integrated into the FHA Single Family On-Line Handbook. These changes will also be included in the Single Family FHA Policy Handbook which will eventually replace HUD Handbook 4155.1

<b>HUD 4155.1, Mortgage Credit Analysis for Mortgage Insurance for One-to-Four Unit Mortgage Loans</b>	
1.A.5.b,	DE Underwriter's Responsibility Upon Loan Approval
1.B.2.a,	General Mortgage Credit Analysis Documents
4.A.1.,	Add new section k, Definition of Minimum Decision Credit Score for Manually Underwritten Loans
4.C.3.c,	Qualifying Ratios for Borrowers with Insufficient Credit
4.C.3.d,	Cash Reserve Requirement for Borrowers with Insufficient Credit
4.C.	Add new section 7.a, Definition of Reserves
4.C.	Add new section 7.b, Cash Reserve Requirements, 1 and 2 Unit Properties
4.C.	Add new section 7.c, Calculation of Reserves
4.D.1.d,	Borrowers Returning to Work After Extended Absences
4.D.2.d,	Qualifying Part-Time Income
4.D.2.j,	Retirement Income
4.D.2.k,	Documentation Requirements for Income from the Social Security Administration
4.E.3.c,	Government Assistance Programs
4.E.4.c,	Income From Roommates in a Single Family Property
4.F.1.a,	Lender Responsibility When Qualifying a Borrower
4.F.2.b,	Mortgage Payment Expense to Effective Income Ratio
4.F.2.c,	Total Fixed Payment to Effective Income Ratio
4.F.3.b,	Compensating Factors Benchmark Guidelines
4.F.3,	Add new section c, Using Residual Income as a Compensating Factor
4.F.3,	Add new section d, Calculating Monthly Income for Residual Income
4.F.3,	Add new section e, Calculating Monthly Expenses for Residual Income
4.F.3,	Add new section f, Residual Income Tables
6.A.2.d,	Underwriting Requirements for Qualifying the Borrower (for Temporary Buydowns)

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### Summary – FHA Guidance for Manually Underwritten Loans

This Mortgagee Letter addresses the following changes in underwriting guidance for manually underwritten loans:

- maximum qualifying ratios for all manually underwritten loans based on the minimum decision credit score;
- revised compensating factors that must be used in order to exceed FHA's standard qualifying ratios; and
- requirement for cash reserves equal to one or more total monthly mortgage payments for manually underwritten loans involving one and two unit properties.

**Reference:** Total monthly mortgage payment is defined in HUD Handbook 4155.1, Chapter 4, Section F.2.b.

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### Definition of Manually Underwritten Loans

Manually underwritten loans include:

- loans involving borrowers without a credit score which were not scored against FHA's TOTAL Scorecard;
- loans receiving a **Refer** scoring recommendation from FHA's TOTAL Scorecard; and
- loans receiving an **Accept** scoring recommendation from FHA's TOTAL Scorecard but which have been downgraded to a **Refer** by the underwriter.

When a loan receiving an **Accept** scoring recommendation is downgraded to a **Refer**, the loan must be underwritten in accordance with all provisions of this Mortgagee Letter.

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### Definition of Minimum Decision Credit Score

A minimum decision credit score is determined for each borrower according to the guidance provided in HUD Handbook 4155.1, Chapter 4, Section.A.1.j. When three scores are available (one from each repository), the median (middle) value is used; when only two are available, the lesser of the two is chosen; when only one is available that score is used.

Where the loan involves multiple borrowers, the mortgagee must determine the minimum decision credit score for each borrower, and then select the lowest minimum decision credit score for all borrowers.

Where the loan involves multiple borrowers and one or more of the borrowers do not have a credit score (non-traditional or insufficient credit), mortgagees shall select the lowest minimum decision credit score of the borrower(s) with credit score(s).

**Example:** The borrower has a minimum decision credit score of 637. One co-borrower has a minimum decision credit score of 619 and the other co-borrower has no credit score. The minimum decision credit score of 619 must be used to determine the maximum ratios.

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### Definition of Reserves

Reserves are defined as:

- the sum of verified and documented borrower funds;  
*minus*
  - the sum the borrower is required to pay at closing, including the cash investment, closing costs, prepaid expenses, any payoffs that are a condition of loan approval, and any other expense required to close the loan;  
*but not including*
  - the amount of cash taken at settlement in cash-out transactions or incidental cash received at settlement in other loan transactions, gift funds in excess of the amount required for the cash investment and other expenses, equity in another property, and borrowed funds from any source.
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### Definition of Reserves (continued)

**Reference:** Refer to HUD Handbook 4155.1, Chapter 5, Section B for more information on acceptable sources and documentation standards for borrower funds.

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### Reserve Requirement

All manually underwritten loans must meet or exceed the following minimum reserve requirements:

- 1 and 2 Unit Properties. Reserves must equal or exceed one total monthly mortgage payment.
- 3 and 4 Unit Properties. Reserves must equal or exceed three total monthly mortgage payments.

This new policy replaces the current 2-month minimum reserve requirement for one and two unit properties for borrowers with insufficient credit.

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### Borrowers with Minimum Decision Credit Scores Below 580 or With Non-traditional or Insufficient Credit

The maximum allowable qualifying ratios for borrowers with minimum decision credit scores below 580 or with non-traditional or insufficient credit are as follows:

- total monthly mortgage payment may not exceed 31% of gross effective monthly income (33% for Energy Efficient Homes); and
- total monthly fixed payment may not exceed 43% of gross effective monthly income (45% for Energy Efficient Homes).

Borrowers with credit scores below 580 or with non-traditional or insufficient credit may not exceed the 31/43 ratios (33/45 for Energy Efficient Homes) regardless of whether they meet one or more compensating factors.

Pursuant to Handbook 4155.1, Chapter 4, Section C.3.c, the qualifying ratios for insufficient credit borrowers are computed using income only from borrowers occupying the property and obligated on the loan. Non-occupant co-borrower income may not be included. Income from non-occupant co-borrowers may be included in the ratios for non-traditional credit borrowers.

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## Mortgagee Letter 2014-02, Continued

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**Borrowers  
With Minimum  
Decision Credit  
Scores of 580 or  
More and No  
Compensating  
Factors**

The maximum allowable qualifying ratios for borrowers with minimum decision credit scores of 580 or more and no compensating factors are as follows:

- total monthly mortgage payment may not exceed 31% of gross effective monthly income (33% for Energy Efficient Homes); and
  - total monthly fixed payment may not exceed 43% of gross effective monthly income (45% for Energy Efficient Homes).
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**Borrowers  
With Minimum  
Decision Credit  
Scores of 580 or  
More and One  
Compensating  
Factor**

The maximum allowable qualifying ratios for borrowers with minimum decision credit scores of 580 or more provided they meet one of the compensating factors specified below are as follows:

- total monthly mortgage payment may not exceed 37% of gross effective monthly income; and
- total monthly fixed payment may not exceed 47% of gross effective monthly income.

Acceptable compensating factors are limited to the following:

- Verified and documented cash reserves that equal or exceed three total monthly mortgage payments (one and two units) or that equal or exceed six total monthly mortgage payments (three and four units);
  - New total monthly mortgage payment is not more than \$100 or 5% higher than previous total monthly housing payment, whichever is less, and there is a documented twelve month housing payment history with no more than one 30 day late payment. In cash-out transactions *all* payments on the mortgage being refinanced must have been made within the month due for the previous twelve months.
  - Residual income (see page 14).
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### **Borrowers With Minimum Decision Credit Scores of 580 or More and Two Compensating Factors**

The maximum allowable qualifying ratios for borrowers with minimum decision credit scores of 580 or more provided they meet two of the compensating factors specified below are as follows:

- total monthly mortgage payment may not exceed 40% of gross effective monthly income; and
- total monthly fixed payment may not exceed 50% of gross effective monthly income.

Acceptable compensating factors are limited to the following:

- Verified and documented cash reserves that equal or exceed three total monthly mortgage payments (one and two units) or that equal or exceed six total monthly mortgage payments (three and four units);
  - New total monthly mortgage payment is not more than \$100 or 5% higher than previous total monthly housing payment, whichever is less, and there is a documented twelve month housing payment history with no more than one 30 day late payment. In cash-out transactions *all* payments on the mortgage being refinanced must have been made within the month due for the previous twelve months.
  - Verified and documented significant additional income that is not considered effective income; and
  - Residual income (see page 14).
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### **Borrowers With Minimum Decision Credit Scores of 580 or More with No Discretionary Debt**

The maximum allowable qualifying ratios for borrowers with minimum decision credit scores of 580 or more *with established credit lines in their own name open for at least six months* who carry no discretionary debt (housing payment is only account with an outstanding balance and borrower can document that revolving credit has been paid off in full monthly for at least the previous six months) are as follows:

- total monthly mortgage payment may not exceed 40% of gross effective monthly income; and
- total monthly fixed payment may not exceed 40% of gross effective monthly income.

For borrowers meeting this criterion no other compensating factors are required.

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### Maximum Qualifying Ratio Matrix

The maximum total monthly mortgage payment to gross effective income ratios and total monthly fixed payments to gross effective income ratios applicable to manually underwritten loans are summarized in the matrix below.

Manual Underwriting Matrix For Case Numbers Issued on or After April 21, 2014		
Lowest Minimum Decision Credit Score	Maximum Qualifying Ratios (%)	Acceptable Compensating factors
500-579 or Non-traditional/ Insufficient Credit	31/43	Not applicable. Borrowers with minimum decision credit scores below 580, or with Non-traditional or Insufficient Credit may not exceed 31/43 ratios.  Energy Efficient Homes may have stretch ratios of 33/45.
580 and above	31/43	No compensating factors required.  Energy Efficient Homes may have stretch ratios of 33/45.
580 and above	37/47	<b>One</b> of the following: <ul style="list-style-type: none"> <li>• Verified and documented cash reserves equal to at least three total monthly mortgage payments (1-2 units) or six total monthly mortgage payments (3-4 units).</li> <li>• New total monthly mortgage payment is not more than \$100 or 5% higher than previous total monthly housing payment, whichever is less; and a there is documented twelve month housing payment history with no more than one 30 day late payment.</li> </ul> <p>In cash-out transactions <i>all</i> payments on the mortgage being refinanced must have been made within the month due for the previous 12 months.</p> <ul style="list-style-type: none"> <li>• Residual Income</li> </ul>

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### Maximum Qualifying Ratio Matrix (continued)

Lowest Minimum Decision Credit Score	Maximum Qualifying Ratios (%)	Acceptable Compensating factors
580 and above	40/40	Borrower has established credit lines in his/her own name open for at least six months but carries no discretionary debt (i.e., monthly total housing payment is only open installment account and borrower can document that revolving credit has been paid off in full monthly for at least the previous six months).
580 and above	40/50	<p><b>Two</b> of the following:</p> <ul style="list-style-type: none"> <li>• Verified and documented cash reserves equal to at least three total monthly mortgage payments (1-2 units) or six total monthly mortgage payments (3-4 units).</li> <li>• New total monthly mortgage payment is not more than \$100 or 5% higher than previous total monthly housing payment, whichever is less; and a there is documented twelve month housing payment history with no more than one 30 day late payment.</li> </ul> <p>In cash-out transactions <i>all</i> payments on the mortgage being refinanced must have been made within the month due for the previous 12 months.</p> <ul style="list-style-type: none"> <li>• Verified and documented significant additional income that is not considered effective income (i.e., part-time or seasonal income verified for more than one year but less than two years).</li> <li>• Residual Income.</li> </ul>

### Recording Compensating Factors

Compensating factors cited to support the underwriting decision must be recorded in the *Underwriter Comments* section of Form [HUD-92900-LT](#), *FHA Loan Underwriting and Transmittal Summary*.

Documentation supporting the compensating factors cited must be included in the endorsement case binder including, if applicable, a worksheet attached to Form [HUD-92900-LT](#) reflecting the calculation of residual income.

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### Energy Efficient Homes

Current policy allows borrowers who are manually underwritten with homes built or retrofitted to exceed the applicable IECC standard including Energy Efficient Mortgages to exceed the 31/43 ratios (33/45 stretch ratios). These borrowers may be eligible for ratios in excess of the 33/45 stretch ratios but not exceeding 37 and/or 47, only if they have a minimum decision credit score of 580 or higher and meet at least any **one** of the compensating factors specified on page 6 of this Mortgagee Letter. Ratios exceeding 37/47 (not to exceed 40 and/or 50) may be approved only if they have a minimum decision credit score of 580 or higher and meet at least any **two** of the compensating factors specified on page 7 of this Mortgagee Letter.

*Example:* A borrower with a credit score of 570 is purchasing an Energy Efficient Home. The maximum allowable ratios are 33/45.

*Example:* A borrower with a credit score of 590 and one compensating factor is purchasing an Energy Efficient Home. The maximum allowable ratios are 37/47.

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### Documenting Acceptable Compensating Factors

The table below describes the compensating factors (and the documentation required to support the compensating factors) that may be used to justify approval of manually underwritten loans with ratios that exceed FHA standard qualifying ratios.

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### Documenting Acceptable Compensating Factors (continued)

<p>Verified and Documented Cash Reserves</p>	<p>Verified and documented cash reserves may be cited as a compensating factor subject to the following requirements.</p> <ul style="list-style-type: none"> <li>• reserves are equal to or exceed three total monthly mortgage payments (one and two units); or</li> <li>• reserves are equal or exceed six total monthly mortgage payments (three and four units).</li> </ul> <p>Funds and/or “assets” that are <i>not</i> to be considered as cash reserves include</p> <ul style="list-style-type: none"> <li>• gifts;</li> <li>• equity from another property;</li> <li>• borrowed funds; and</li> <li>• cash received at closing in a cash-out refinance transaction or incidental cash received at closing in the loan transaction.</li> </ul> <p>The mortgagee may use a portion of a borrower's retirement account (IRA, Thrift Savings Plan, 401k, and Keogh accounts) to calculate cash reserves, subject to the following conditions:</p> <ul style="list-style-type: none"> <li>• to account for withdrawal penalties and taxes, only 60% of the vested amount of the account, less any outstanding loans, may be used. The mortgagee must document the existence of the account with the most recent depository or brokerage account statement. In addition, evidence must be provided that the retirement account allows for withdrawals under conditions other than in connection with the borrower's employment termination, retirement, or death.</li> </ul>
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## Mortgagee Letter 2014-02, Continued

### Documenting Acceptable Compensating Factors (continued)

Verified and Documented Cash Reserves (continued)	<ul style="list-style-type: none"> <li>if withdrawals can be made only in connection with the borrower's employment termination, retirement, or death, the retirement account may not be used to calculate the borrower's cash reserves. If any of these funds are also to be used for loan settlement, that amount must be subtracted from the amount included as cash reserves.</li> </ul>
Minimal Increase in Housing Payment	<p>A minimal increase in housing payment may be cited as a compensating factor subject to the following requirements:</p> <ul style="list-style-type: none"> <li>the new total monthly mortgage payment does not exceed the current total monthly housing payment by more than \$100 or 5%, whichever is less; <u>and</u></li> <li>there is a documented twelve month housing payment history with no more than one 30 day late payment. In cash-out transactions <i>all</i> payments on the mortgage being refinanced must have been made within the month due for the previous 12 months.</li> <li>If the borrower has no current housing payment mortgagees may not cite this compensating factor.</li> </ul> <p><b>Reference:</b> Refer to HUD Handbook 4155.1, Chapter 1, Section B.2.a for information on documenting the previous housing payment.</p>
No Discretionary Debt	<p>No discretionary debt may be cited as a compensating factor subject to the following requirements:</p> <ul style="list-style-type: none"> <li>the borrower's housing payment is the only open account with an outstanding balance that is not paid off monthly;</li> <li>the credit report shows established credit lines in the borrower's name open for at least six months; and</li> <li>the borrower can document that these accounts have been paid off in full monthly for at least the past six months).</li> </ul>

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### Documenting Acceptable Compensating Factors (continued)

No Discretionary Debt (continued)	Borrowers who have no established credit other than their housing payment, no other credit lines in their own name open for at least six months, or who cannot document that all other accounts are paid off in full monthly for at least the past six months, do not qualify under this criterion. Credit lines not in the borrower's name but for which he or she is an authorized user do not qualify under this criterion.
Significant Additional Income Not Reflected in Gross Effective Income	<p>Additional income from bonuses, overtime, part-time or seasonal employment that is not reflected in gross effective income can be cited as a compensating factor subject to the following requirements</p> <ul style="list-style-type: none"> <li>• the mortgagee must verify and document that the borrower has received this income for at least one year, and it will likely continue; and</li> <li>• the income, if it were included in gross effective income, is sufficient to reduce the qualifying ratios to not more than 37/47.</li> </ul> <p>Income from non-borrowing spouses or other parties not obligated for the mortgage may not be counted under this criterion.</p> <p>This compensating factor may be cited only in conjunction with another compensating factor when qualifying ratios exceed 37/47 but are not more than 40/50.</p>
Residual Income	Residual income may be cited as a compensating factor provided it can be documented and it is at least equal to the applicable amounts for household size and geographic region found on the <i>Table Of Residual Incomes By Region</i> found in VA Pamphlet 26-7 (see Page 14 of this Mortgagee Letter).

### VA Guidance on Residual Income

FHA has modeled the calculation of residual income on underwriting guidance provided by the Department of Veterans Affairs (VA) in Chapter 4 of VA Pamphlet 26-7 at [http://www.benefits.va.gov/warms/pam26\\_7.asp](http://www.benefits.va.gov/warms/pam26_7.asp), as modified in this Mortgagee Letter. FHA is also using the tables from the VA guidelines for the determination of whether residual income is sufficiently high to qualify as a compensating factor.

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### Calculating Residual Income

Residual income is calculated in accordance with the following:

- Calculate the total gross monthly income of all **occupying borrowers**.
- Deduct from gross monthly income the following items:

<b>Residual Income, Deductions From Gross Monthly Income</b>
State income taxes
Federal income taxes
Municipal or other income taxes
Retirement or Social Security
Proposed total monthly fixed payment
Estimated maintenance and utilities
Job related expenses (e.g., child care)

- Subtract the sum of the deductions from the table above from the total gross monthly income of all occupying borrowers.
- The balance is residual income.

**Reference:** Total monthly fixed payment is defined in HUD Handbook 4155.1, Chapter 4, Section F.2.c.

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### Calculating Gross Monthly Income

- Gross monthly income should be calculated only for the occupying borrowers consistent with the requirements of HUD Handbook 4155.1, Chapter 4, Section D.
- Do not include bonus, part-time or seasonal income that does not meet the requirements for effective income as stated in HUD Handbook 4155.1, Chapter 4, Section 2.b-e.
- Do not include income from non-occupying co-borrowers, co-signers, non-borrowing spouses, or other parties not obligated on the mortgage.

Because taxes are taken into account in the calculation of residual income, non-taxable income may not be “grossed up.”

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### Calculating Monthly Expenses

- If available, mortgagees must use Federal and state tax returns from the most recent tax year to document state and local taxes, retirement, Social Security and Medicare. If tax returns are not available, mortgagees may rely upon current pay stubs.
- For estimated maintenance and utilities in all states, mortgagees should multiply the living area of the property (square feet) by \$0.14.

*Example:*

	1,500 square feet
	<u>x .14</u>
	\$210.00 per month

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### Using Residual Income as a Compensating Factor

To use residual income as a compensating factor, count all members of the household of the occupying borrowers without regard to the nature of their relationship and without regard to whether they are joining on title or the note.

**Exception:** As stated in the VA Guidelines, the mortgagee may omit any individuals from "family size" who are fully supported from a source of verified income which is not included in effective income in the loan analysis. These individuals must voluntarily provide sufficient documentation to verify their income to qualify for this exception.

From the table below, select the applicable loan amount, region and household size. If residual income equals or exceeds the corresponding amount on the table, it may be cited as a compensating factor.

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Using Residual  
Income as a  
Compensating  
Factor  
(continued)

<b>Table of Residual Incomes by Region For loan amounts of \$79,999 and below</b>				
<b>Family Size</b>	<b>Northeast</b>	<b>Midwest</b>	<b>South</b>	<b>West</b>
1	\$390	\$382	\$382	\$425
2	\$654	\$641	\$641	\$713
3	\$788	\$772	\$772	\$859
4	\$888	\$868	\$868	\$967
5	\$921	\$902	\$902	\$1,004
over 5	Add \$75 for each additional member up to a family of seven.			
<b>Table of Residual Incomes by Region For loan amounts of \$80,000 and above</b>				
<b>Family Size</b>	<b>Northeast</b>	<b>Midwest</b>	<b>South</b>	<b>West</b>
1	\$450	\$441	\$441	\$491
2	\$755	\$738	\$738	\$823
3	\$909	\$889	\$889	\$990
4	\$1,025	\$1,003	\$1,003	\$1,117
5	\$1,062	\$1,039	\$1,039	\$1,158
over 5	Add \$80 for each additional member up to a family of seven			

**States Included  
in Regions**

The Regions on the Table of Residual Income include the following states:

<b>Region</b>	<b>States</b>
Northeast	CT, MA, ME, NH, NJ, NY, PA, RI, VT
Midwest	IA, IL, IN, KS, MI, MN, MO, ND, NE, OH, SD, WI
South	AL, AR, DC, DE, FL, GA, KY, LA, MD, MS, NC, OK, PR, SC, TN, TX, VA, VI, WV
West	AK, AZ, CA, CO, HI, ID, MT, NM, NV, OR, UT, WA, WY

**Note:** HUD is adopting this VA guidance solely for the purposes of calculating residual income for use as a compensating factor on manually underwritten loans. Other VA underwriting policies cannot be used in connection with FHA loans, or cited as compensating factors.

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**Information  
Collection**

The information collection requirements contained in this document have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) and assigned OMB control number 2502-0059. In accordance with the Paperwork Reduction Act, HUD may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a currently valid OMB control number.

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**Questions**

Please address any questions about the topics addressed in this Mortgagee letter to the FHA Resource Center at (800) 225-5342. Persons with hearing or speech impairments may reach this number via TTY by calling the Federal Relay Service at (800) 877-8339. For additional information on this Mortgagee Letter, please visit [www.hud.gov/answers](http://www.hud.gov/answers).

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**Signature**

Carol J. Galante  
Assistant Secretary for Housing-Federal Housing Commissioner

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