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U. S. Department of Housing and Urban Development
Washington, D.C. 20410-8000

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OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER
MORTGAGEE LETTER 94-2

TO: ALL APPROVED MORTGAGEES
SPECIAL ATTENTION: Nonprofit Agencies with Affordable Housing
Programs State Housing Finance Agencies
SUBJECT: Secondary Financing Provided by Nonprofit Agencies and
Transferability Restrictions Permitted for Property with
a HUD Insured Mortgage

The Department issued a final rule effective on September 10, 1993, to revise the Department's policy concerning secondary financing provided by nonprofit agencies with affordable housing programs, and to clarify the use of single family mortgage insurance for properties that are not freely transferable by the borrower/homeowner because of legal restrictions. This Mortgagee Letter will summarize main points and provide additional clarification for certain issues. The rule also includes provisions that are not discussed below, such as procedures for release of selling mortgagors which will be addressed in a separate issuance.

I. SECONDARY FINANCING BY NONPROFIT AGENCIES

HUD has long recognized the important role that nonprofit agencies may play in providing affordable housing opportunities. The revised rule will permit nonprofit agencies greater flexibility in providing downpayment and other assistance to prospective homeowners through secondary financing. HUD Field Offices will determine whether a nonprofit agency meets the eligibility criteria for providing secondary financing and will also approve the secondary financing.

An eligible nonprofit agency must be of the type described in Section 501(c)(3) as exempt from taxation under Section 501(a) of the Internal Revenue Code of 1986; have two years' experience as a provider of housing for low- and moderate-income persons; and have a voluntary board with no part of the net earnings or contributions of the organization benefiting any member, founder, contributor, or individual. Eligible nonprofit agencies may be permitted to provide secondary financing provided the borrower has made or will make at settlement a cash investment of at least equal to three (3) percent of the cost to acquire the property. The cash investment requirement may also be satisfied with grant funds provided under the HOME Investment

Partnerships (HOME) program. The secondary financing arrangements are also subject to the restrictions below as well as those detailed in HUD Handbook 4155.1 REV-4, paragraph 1-13(C), as follows:

1. The required monthly payment under both the insured mortgage and the second mortgage or lien, plus other housing expenses and all recurring charges, cannot exceed the borrower's reasonable ability to pay;
2. The second mortgage when combined with the first may not exceed the estimated value of the property including all closing costs; and
3. The source, amount, and repayment terms must be disclosed in the mortgage application and the borrower must acknowledge that he or she understands and agrees to those terms.

However, a nonprofit agency meeting the additional criteria for being considered as "instrumentality of government" may be permitted to provide secondary financing for as much as 100 percent of the borrower's required cash investment (subject to the restrictions 1 through 3 stated above). For a nonprofit agency to be considered an "instrumentality of government" it must meet criterion "A" below, as well as one of either B1, B2, or B3.

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| A. | ESTABLISHMENT | Must have been established by a governmental body or with governmental approval or under special law to serve a particular public purpose or designated as an instrumentality by law (statute or court opinion), and |
| B1. | ORGANIZATIONAL CONTROL | Majority of governing board and/or principal officers named or approved by governmental body/officials, or |
| B2. | OPERATIONAL CONTROL | Government body approves all major decisions and/or expenditures, or |
| B3. | FINANCIAL CONTROL | Government body provides funds through direct appropriations/grants/loans, with related controls applicable to all activities of entity. |

If the secondary financing includes restrictions on transferability under the new rule, such as occupancy requirements or resale restrictions, those requirements must comply with the new rule (as discussed below). Permitted restrictions may be enforced by requiring repayment of the secondary financing. The secondary financing itself is not a restriction under the rule merely because it is due on sale of the home.

Federal agencies and government-sponsored enterprises (e.g., the Federal Deposit Insurance Corporation (FDIC), the Federal National Mortgage Corporation (Fannie Mae), the Resolution Trust Corporation (RTC), the Federal Home Loan Mortgage Corporation (Freddie Mac)) that administer affordable housing programs may also provide secondary financing under the terms described above.

II. RESTRICTIONS TO TRANSFERABILITY -- SUMMARY OF RULE

The rule states the long-standing HUD policy that a property with a HUD-insured mortgage shall be free of restrictions that prevent the borrower from freely transferring the property. The rule also prohibits a lender from approving restrictions after the loan is closed. The rule uses the term "legal restrictions on conveyance" to describe such restrictions and this term is broadly defined to include provisions in any kind of legal instrument that would cause a conveyance (including a lease) by the borrower to:

- o Be void, or voidable by a third party.
- o Be the basis of contractual liability of the borrower.
- o Terminate, or subject to termination, the borrower's interest in the property.
- o Be subject to the consent of a third party.
- o Be subject to limits on the amount of sales proceeds a borrower can retain.
- o Be grounds for accelerating the insured mortgage.
- o Be grounds for increasing the interest rate of the insured mortgage.

If a conveyance could cause any of these things to occur, the property is considered to be subject to legal restrictions on conveyance (referred to as "restrictions" for the remainder of this Mortgagee Letter) and is usually ineligible for HUD mortgage insurance.

However, the rule also describes the circumstances when restrictions do not make the property ineligible. They are:

- o HUD-required restrictions on sale to non-creditworthy persons or persons who will not occupy the property as a principal residence. These restrictions are contained in the standard mortgage language required by HUD. (Handbook 4155.1 Rev. 4, paragraph 4-2; Handbook 4165.1 Rev. 1, Appendix III, paragraph 9(b); Handbook 4330.1 Rev. 4, paragraph 6-4.)

- o Restrictions that are part of an eligible program for low- or moderate-income housing (referred to as an "affordable housing program" for the remainder of this Mortgagee Letter) and consistent with requirements of the rule. An eligible program must be operated pursuant to a Federal program, or operated by a State or local government or an eligible nonprofit organization as defined in the rule. These restrictions are discussed in greater detail below.

- o Restrictions related to tax-exempt mortgage revenue bond financing. In addition to the restrictions allowed for governmental or non-profit affordable housing programs, the lender may use HUD's tax-exempt financing rider to provide for mortgage acceleration for violation of restrictions. (Handbook 4165.1 Rev 1, Appendix XII.)

- o Restrictions for housing for the elderly. These are allowed if consistent with Federal, State and local laws and if marketability is not unduly affected.

- o Restrictions related to the special title situations on Indian lands, Hawaiian Homelands, the Northern Mariana Islands and American Samoa. These will not necessarily preclude mortgage insurance.

LIMITATIONS ON RESTRICTIONS -- AFFORDABLE HOUSING PROGRAMS

All restrictions relating to affordable housing programs that are otherwise allowed by HUD policy must automatically and permanently terminate upon foreclosure, deed-in-lieu of foreclosure, or assignment of the insured mortgage to HUD. The relevant legal documents must have language that accomplishes this result. Merely subordinating the restrictions to the insured mortgage is not sufficient. The restrictions cannot come back in force upon subsequent resale by the lender or HUD (except as provided in regulations for the HOME program).

Restrictions may not be enforced by any of the following consequences for a violation:

- o Voiding a conveyance by the borrower.
- o Terminating the borrower's interest in the property.
- o Accelerating the insured mortgage.
- o Increasing the interest rate for the insured mortgage.
- o Subjecting the borrower to contractual liability.

The prohibition against contractual liability covers liability for damages, specific performance or injunctive relief. It does not prevent a requirement for the borrower to

repay with reasonable interest any assistance received in connection with the borrower's home purchase. The effect of these prohibitions is that the borrower must have the legal ability to sell his or her home. The borrower does not have to be allowed to retain the benefit of any financial assistance and, as provided below, the borrower does not have to be allowed to retain all sales proceeds. The borrower also may be required to sell to the holder of an option or right of refusal designed to continue the property as affordable housing.

The prohibition against terminating the borrower's interest means that the borrower must have fee simple absolute title instead of title that is dependent on subsequent events such as fee simple determinable or fee simple subject to a condition or a limitation. For example, a program in which the borrower may lose title if the borrower fails to occupy the property for a specified number of years is not allowed. One exception permits such an arrangement for a Section 203(k) rehabilitation loan as long as the other holder of interests in title also executes the mortgage.

An affordable housing program must be designed to serve borrowers with a household income not to exceed 115% of the median area income, unless the local HUD Office with the concurrence of HUD Headquarters has approved a higher income in writing (not to exceed 140% of the median area income). Currently, the only area with an approved higher income limit is Hawaii, with a limit of 140%.

SPECIFIC RESTRICTIONS ALLOWED FOR AFFORDABLE HOUSING

HUD's regulation permits a variety of types of restrictions including limits to the resale price of the property or recaptures of equity. A maximum sales price may be imposed or the sales proceeds due the borrower may be limited (with any excess payable to a governmental body or nonprofit organization for reuse in an affordable housing program). In either case, when the homeowner sells the property, he or she must be permitted to recover at least the original purchase price, sales commission, cost of capital improvements, and any accrued negative amortization if the property was financed with a graduated payment mortgage. In addition, homeowners must be permitted to recover a reasonable amount of appreciation as determined by HUD. Appreciation is measured by the difference between the original purchase price and the actual price at which the property is resold. If the program permits the homeowners to sell the property at market value but recaptures part of the equity, HUD considers a reasonable share of appreciation to be at least 50 percent. HUD does not object to affordable housing schemes whereby the homeowner's share of appreciation is on a sliding scale beginning at zero, provided that within 2 years the homeowner would be permitted to retain 50 percent of the appreciation. If the program sets a maximum sales price restriction, the borrower must be permitted to retain 100 percent of the appreciation. The Department

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recognizes that other arrangements for sharing appreciation may be acceptable. HUD Field Offices may determine the reasonableness of the appreciation share in local programs without specific written approval from HUD Headquarters.

One method commonly used to ensure that housing remains part of an affordable housing program is for the program sponsor or administrator to hold a right of first refusal or an option right that can be exercised when the borrower proposes to sell the home to a purchaser not eligible for the program benefits. This is permitted by HUD policy if: (a) the rights are held only by a governmental body or eligible nonprofit organization and exercised by them or someone they have identified as an eligible purchaser, (b) any right is exercised within 45 days after the holder of these rights may exercise them (for example, the rights are often triggered by a notice of sale from the borrower), and (c) any option price allows the borrower to recover his or her investment plus a reasonable share of appreciation as explained above. The rule permits HUD Headquarters to approve option rights to be held and exercised by another person or entity on a case-by-case basis.

Other permissible restrictions for affordable housing programs are described in the rule. Restrictions that are not described in the rule are not allowed, unless HUD approved the restriction in writing before the rule took effect.

EFFECT OF PREVIOUS APPROVAL

Previous written approval of restrictions is not affected by the new rule as long as the approval is restricted to property that was

identifiable at the time of approval. Endorsement of a mortgage for insurance does not constitute written approval of restrictions applicable to the mortgaged property. Thus, a letter from the jurisdictional HUD Office approving restrictions intended for a particular community, neighborhood, subdivision or condominium project can still be relied upon by a lender even if the restrictions do not conform to the new rule. The restrictions cannot be applied to a different location unless they are modified to conform to the new rule. If restrictions were approved without a specific property identified, the approval will not excuse the lender from compliance with the new rule.

RELATIONSHIP TO OTHER FEDERAL PROGRAMS

Restrictions are required by some other Federal programs, such as the Homeownership and Opportunity for People Everywhere (HOPE) and HOME programs and the Affordable Housing Disposition Programs of the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC). Because the policies stated in the rule are designed to protect the financial interests of the FHA insurance funds, there may be some instances when restrictions designed to carry out the purposes of a Federal affordable housing program conflict with the rule. The rule recognizes some conflict with HOPE and HOME requirements in areas such as rights of first refusal, and

HUD will attempt to apply its rule to minimize any conflict between programs, including consideration of requests for appropriate rule waivers.

The RTC has developed a model land use restriction agreement for lower-income households (LURA, form no. SFLURA-1 Version 2.0) containing restriction on conveyance which has been approved by HUD Headquarters. This model LURA may be used in connection with the RTC Affordable Housing Disposition Program and may serve as a model for other state and local affordable housing programs. However, lenders, HUD Field Offices and program sponsors are cautioned that the language in the RTC SFLURA-3 and the CONDOLURA and other restriction agreements issued by the RTC prior to the SFLURA-1 do not have HUD approval. Restrictions contained in documents other than the SFLURA-1 must be reviewed for compliance with HUD requirements.

The FDIC also has developed deed recapture language (revised 6-18-93) for its Affordable Housing Program which has been approved by HUD.

RESTRICTIONS SHOULD BE UNDERSTANDABLE

The Departmental policy is to discourage restrictions that are not simply stated and understandable to the typical homebuyer. Sometimes restrictions must be contained in complex legal documents. If it is not feasible to simplify the legal documents, a simplified explanation or disclosure of applicable restrictions should be provided to the borrower. This is particularly important when the restrictions are contained in complex legal documents originally drafted to apply to the owner of a multifamily property such as a condominium developer. A simplified

explanation helps the lender determine whether the required certification of compliance with regulations can be made.

DE CERTIFICATION

The lender will be responsible for determining that the property is free of restrictions except as permitted by the rule. The following certification is added to the list of Direct Endorsement (DE) certifications in Appendix 4 of Handbook 4000.4 Rev. 1, Chg. 1:

(5A) The property is free of legal restrictions on conveyance as required by 24 CFR 203.41, 203.512 or 234.66, except for restrictions specifically permitted by those regulations.

This certification will be in effect for all mortgages executed on or after 30 days from the date of this Mortgagee Letter.

The Department recognizes that restrictions relating to affordable housing programs are often complex and that it may be difficult for lenders to determine whether

the programs comply with HUD policies. The Department also recognizes that governmental or nonprofit program sponsors may develop the restrictions before specific lenders are identified. The Field Offices will assist lenders and program sponsors in determining whether proposed restrictions are acceptable. Field Offices are not responsible for approving specific restrictions or for determining whether they will be enforceable under applicable law. Unusual or difficult questions should not be submitted directly to HUD Headquarters by lenders or program sponsors, but Field Offices may seek the assistance of the Office of Insured Single Family Housing, Mortgage Credit Branch at 202-708-2700 regarding policy matters or the Office of General Counsel, Home Mortgage Division at 202-708-1272 regarding legal matters.

Lenders that are working with the sponsors of affordable housing programs should make sure that the sponsors have a copy of the rule and this Mortgagee Letter.

III. LEASE TERMINATION

Any lease must meet the requirements of Handbook 4010.1 Chg 10, paragraph 3-1 (September 10, 1981) and 4150.1 Rev-1, paragraph 6-32, as well as the new rule. The handbooks require a lease to provide the lender a right to correct lessee (borrower) defaults upon receipt of a notice of intent to terminate the lease. In order for this lender's right to be meaningful, a lease should not be terminable due to a violation the lender cannot correct.

The handbooks and the rule should be interpreted together. The rule will prohibit restrictions that could result in lease termination if the restrictions are violated. For example, the lessor should not be able to terminate a lease if the lessee/borrower fails to continue to occupy a property. Such a termination provision would violate the handbook because

the lender could not correct the violation, and it would violate the rule because even occupancy requirements generally permitted for affordable housing programs cannot be the basis for terminating the borrower's interest in the property.

Ordinarily, lease terminations unrelated to affordable housing restrictions and correctable by the lender, such as termination for nonpayment of rent, are permitted and are not affected by the rule. The Department does not intend to prevent affordable housing programs such as community land trusts that depend on ground leases, but standard documents for such programs should be reviewed carefully for compliance with the rule and modified as needed.

IV. CONDOMINIUM POLICIES

- A. Rights of First Refusal. Previous HUD policy allowed HUD to approve an existing condominium project with a right of first refusal held by the condominium association. The rule changes this policy. Condominiums

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approved by HUD Offices before the rule took effect are not affected by the change in policy. HUD offices will refuse a new request for approval for a project with rights of right refusal if a condominium association holds the rights; other right of first refusal arrangements are acceptable only as permitted for affordable housing programs.

- B. Leases of Less than 6 Months. Restrictions on leasing generally are allowed only to the extent that the rule allows restrictions on sale. HUD will continue to approve condominium projects which restrict leases to six months or longer, and such HUD-approved restrictions will not be considered restrictions in violation of the rule.

If you have questions concerning this Mortgage Letter, please contact the Mortgage Credit Branch at your local HUD Field Office.

Sincerely yours,

Nicolas P. Retsinas
Assistant Secretary for Housing
- Federal Housing Commissioner