



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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

November 14, 2002

MORTGAGEE LETTER 2002-22

**TO: ALL GOVERNMENT AGENCIES
ALL APPROVED MORTGAGEES
ALL APPROVED NONPROFIT AGENCIES**

SUBJECT: Downpayment Assistance Programs Operated by Governmental Agencies and Nonprofits Using Subordinate Financing

Over the past few months, FHA has received several questions about downpayment assistance programs operated by governmental agencies and nonprofits. The purpose of this Mortgagee Letter is to provide technical guidance to mortgagees about these downpayment assistance programs by summarizing existing program rules and requirements, based on Section 528 of the National Housing Act.

A. State and Local Governments and Nonprofit Instrumentalities of Government

Section 528 of the National Housing Act requires FHA to insure first mortgages with second mortgages or loans made or held by any state or local government agency or instrumentality of government, provided all FHA requirements are met. Mortgagee Letter 94-2 describes the conditions that a nonprofit must meet in order to be considered an instrumentality of government and, thus, eligible to provide secondary financing for as much as 100% of the borrower's required cash investment. To obtain this status, according to Section 528 of the National Housing Act, the nonprofit must be an entity "established by a governmental body or with governmental approval or under special law to serve a particular public purpose or designated by law (statute or court opinion)." FHA also requires that the unit of government that *established* the nonprofit also must either exercise organizational control, operational control, or financial control of the nonprofit in its entirety or, at minimum, the specific homebuyer assistance program that is using FHA's credit enhancement. As described in ML 00-08 and ML 01-02, our Homeownership Centers (HOCs) may review applications from nonprofits that purport to be instrumentalities of government and make approval decisions based on information submitted by the nonprofit.

The policies discussed in ML 94-2 have enabled state and local governments, by themselves or through nonprofit instrumentalities established by the governmental units, to operate successful downpayment assistance programs. However, mortgagees must be aware that

only the actual units of government or their established nonprofit instrumentalities may provide the second lien under the 100 percent financing policies acceptable to FHA.

B. Information Regarding the Second Lien

The second lien itself must be made or held by the eligible governmental body or instrumentality. Neither governmental units nor their established nonprofit instrumentalities may use “agents,” including other nonprofits or for-profit enterprises to make the second lien regardless of the source of those funds. In other words, even if the funds used for the secondary financing were *derived* from an acceptable source such as HUD HOME funds or from a unit of government or the eligible nonprofit instrumentality, the subordinate lien must be in the name of the eligible entity, i.e., the state, county, city or eligible nonprofit instrumentality must be the lien holder. This authority cannot be delegated to another party that is not itself permitted to provide this level of secondary financing. These other entities, however, may be used to *service* the subordinate lien if regularly scheduled payments are to be made by the mortgagor.

In addition, in accordance with 24 CFR 203.41, if the subordinate lien includes any restrictions on transferability, such as occupancy requirements or resale restrictions, those 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. It is also important to note that “forgivable” second liens (e.g., no repayment if the homeowner remains in the house for five years) are not *gifts* and, thus, are subject to these requirements.

The FHA-insured **mortgage amount** is calculated by applying the maximum loan-to-value multipliers based on location of the property and value, as described in ML 98-29, to the lesser of the sales price or appraised value and making certain that there is at least a 3 percent cash investment (which may be met with proceeds from the second lien). The *combined* loan-to-value (CLTV) is limited to the amount to acquire the property, which may include the sales price, closing costs, prepaid expenses, and discount points, and in some cases, the costs for property rehabilitation; this may *not*, however, result in any cash back to the borrower. As an example, a \$100,000 sales price would yield a \$97,000 FHA mortgage amount. Combined with \$3,500 for closing costs and prepaid expenses being paid by the nonprofit, the combined indebtedness could equal \$103,500 with secondary financing equaling \$6,500.

In addition, the combined indebtedness may exceed the value of the property if the governmental unit or nonprofit instrumentality of government is supporting or engaging in a neighborhood revitalization effort. In many cases, the combined indebtedness including the amount spent for rehabilitation cannot be supported by the property’s value after completing the improvements; these revitalization programs are usually designed to increase property values of in the neighborhood over an extended period of time. Subject to approval by the HOC, the subordinate financing, when combined with the FHA-insured first mortgage, may exceed the value of the property even after rehabilitation has been completed. Repayment of the subordinate lien is due only when the property is sold or the mortgage is paid in full.

As an example, a \$100,00 sales price would yield a \$97,000 FHA mortgage amount. Combined with \$3,500 for closing costs and prepaid expenses being paid by the nonprofit, along with \$20,000 for rehabilitation, the combined indebtedness could equal \$123,500 with secondary financing equaling \$26,500. The after-rehabilitation appraised value, however, is only \$120,000. Nevertheless, provided there are assurances that the funds for rehabilitation are expended only for that purpose and not given to the homebuyer, the HOC can approve revitalization programs that result in the costs of the improvements exceeding their effect on value.

C. Nonprofits with FHA-Approved Affordable Housing Programs

In accordance with ML 00-08 and ML 02-01, when a nonprofit that is *not* recognized by FHA as an instrumentality of government is providing subordinate financing *and* that nonprofit *has* obtained FHA's approval as a provider of subordinate financing, the nonprofit may provide downpayment assistance that covers the gap between the FHA first mortgage and amount to acquire the property, minus the required homebuyer's minimum cash investment requirement of three percent.

The FHA-insured **mortgage amount** is calculated by applying the maximum loan-to-value multipliers based on the location of the property and value, as described in Mortgagee Letter 98-29, to the lesser of the sales price or appraised value and making certain that there is a 3 percent cash investment (which may *not* be met with proceeds from the second lien.) The *combined* loan-to-value (CLTV) is limited to the amount to acquire the property, pay closing costs, prepaid expenses, and discount points minus the statutory 3 percent investment which may come from the homebuyer's own funds or from a legitimate gift from an acceptable source.

As an example, a \$100,000 sales price would yield a \$97,000 FHA mortgage amount. Combined with \$3,500 for closing costs and prepaid expenses being paid by the nonprofit, the combined indebtedness could equal \$100,500 with secondary financing equaling \$3,500. The 3 percent required investment may not come from any subordinate liens.

D. Mortgage Amount Limitations When the Downpayment Assistance Provider is Also the Seller of Property

In accordance with Section 528 of the National Housing Act, the combined loan-to-value (CLTV) or indebtedness may be affected when the downpayment assistance provider is also the seller. All sellers are permitted to pay the homebuyer's closing costs, prepaid expenses, and discount points up to an amount equaling six percent of the sales price; any amount above this threshold results in a dollar-for-dollar reduction to the loan amount. Similarly, if a governmental unit or nonprofit is providing a gift of equity from the sale of the property, there must a dollar-for-dollar reduction to the sales price.

E. Mortgagee Letter 2002-02

ML 2002-02 was issued on January 16, 2002 to clarify and amplify that FHA's existing underwriting policy does not permit gifts to borrowers from third parties when such gifts are used to pay off or reduce their outstanding consumer debt to enable them to qualify for FHA-insured mortgages and the third parties receive contributions from the sellers for payment of these debts. ML 2002-02 referred to nonprofit organizations because our experience has indicated that such entities are the only ones that have engaged in this practice. References in ML 2002-02 to nonprofit organizations should be construed as references to any third parties. For example, a gift for debt payoff assistance from a family member is not ordinarily prohibited unless the family member making the gift receives the funds from the seller or any other party with an interest in the transaction.

Questions have arisen with regard to application of ML 2002-02 to gifts made for downpayment assistance in situations in which donors receive contributions from sellers. ML 2002-02 is limited to debt payoff assistance, not downpayment assistance. ML 2002-02 does not apply to gifts for downpayment assistance by nonprofit organizations or other third parties that receive contributions from sellers or other parties with interests in the transactions, provided that such contributions are made after closing.

F. Mortgagee Roster Verification

Mortgagees must verify that nonprofits providing secondary financing are approved by HUD for that activity specifically by consulting the Nonprofit Organization Roster, a listing of nonprofits that HUD has determined are qualified to participate in certain specified FHA single family activities, including providing secondary financing. HUD recently (June 6, 2002) published final regulations governing roster placement and removal of nonprofit entities. The rules became effective on July 8, 2002. The Roster can be accessed on HUD's web site at http://www.hud.gov/offices/hsg/sfh/np/np_hoc.cfm

If you have any questions regarding this Mortgagee Letter, please contact your Homeownership Center in Atlanta (888) 696-4687; Denver (800) 543-9378; Philadelphia (800) 440-8647, or Santa Ana (888) 827-5605.

Sincerely,

John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner