

**DEPARTMENT OF HOUSING AND
URBAN DEVELOPMENT****24 CFR Part 203**

[Docket No. FR-4469-P-01]

RIN 2502-AH38

Sources of Homeowner Downpayment

AGENCY: Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

ACTION: Proposed rule.

SUMMARY: HUD proposes to establish specific standards regarding the mortgagor's investment in the mortgaged property when a gift is provided by a charitable or other nonprofit organization. A gift could not be used for the mortgagor's investment if the organization received funds for the gift—directly or indirectly—from the seller of the property. The proposed rule is intended to prevent a seller from providing funds to an organization as a quid pro quo for that organization's downpayment assistance for purchases of one or more homes from the seller. In addition, HUD proposes to redraft in a more readable, accurate and up-to-date form, without substantive change in policy, the current regulation on the mortgagor's investment in the property.

DATES: *Comments Due Date:* November 15, 1999.

ADDRESSES: Interested persons are invited to submit comments regarding this proposed rule to the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410-0500. Communications should refer to the above docket number and title. Facsimile (FAX) comments are not acceptable. A copy of each communication submitted will be available for public inspection and copying between 7:30 a.m. and 5:30 p.m. weekdays at the above address.

FOR FURTHER INFORMATION CONTACT: Vance Morris, Director, Home Mortgage Insurance Division, Room 9266, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410-8000, (202) 708-2700 (this is not a toll-free number). For hearing- and speech-impaired persons, this number may be accessed via TTY (text telephone) by calling the Federal Information Relay Service at 1-800-877-8339.

SUPPLEMENTARY INFORMATION:**Background**

This proposed rule would accomplish two purposes. Its primary purpose is to

publish for public comment a proposal to establish specific standards regarding the use of gifts by charitable or other nonprofit organizations as a source of the mortgagor's investment in the mortgaged property. Gifts could not be made from funds that the organization received—directly or indirectly—from the seller of the property. In addition, we propose to take this opportunity to redraft in a more readable, accurate and up-to-date form, without substantive change in policy, current § 203.19 on the mortgagor's investment in the property.

Section 203(b)(9) of the National Housing Act requires mortgagors (with narrow exceptions) to pay on account of the property at least 3 percent of the cost of acquisition in order for the mortgage to be eligible for insurance by FHA. The statute, and the implementing regulation at 24 CFR 203.19, are silent about permissible and/or impermissible sources of the mortgagor's investment, except that some loans are permitted sources under the statute and other sources (by implication) are not permitted sources. For example, legislation was enacted in 1996 to amend section 203(b)(9) of the National Housing Act to permit family members to provide gifts and loans to other family members.

FHA has specified through its handbooks and mortgagee letters a broad range of other permissible sources of the mortgagor's investment beyond the homebuyer's own cash savings, none of which include the seller of the property. In addition to loans permitted by statute, permissible sources include gifts from family members, the borrower's employer or labor union, governmental agencies and public entities engaged in the provision of homeownership assistance, and charitable organizations. It is this last group that is of concern.

Proposed Substantive Change

Although FHA has attempted to preclude downpayment funding derived from the seller of the property, either directly or indirectly, some charitable organizations have been able to circumvent these restrictions in various ways, including the establishment of a fund that provides the "gift" to the homebuyer. However, the fund is immediately replenished by the seller providing a "charitable donation" or paying a "service fee" to the nonprofit from the proceeds of the sale of the house and does so only if the homebuyer is using the charitable organization's downpayment assistance program. There is a clear quid pro quo between the homebuyer's purchase of

the property and the seller's "contribution" or payment to the nonprofit organization.

FHA has several concerns with these programs. First, borrowers with limited cash investments into the sale transactions represent significantly greater risk to the insurance fund. In many cases, homebuyers using these downpayment assistance programs need only one percent of their own money for the downpayment. In some programs, they are not required to invest any cash at all. While many States and public entities may have similar programs regarding the homebuyer's cash investment requirements, those programs generally carry with them substantive underwriting criteria above and beyond FHA's minimum standards as well as program eligibility requirements (usually restrictions on the borrower's maximum income so that the program benefits low- and moderate-income clients); these are generally missing in the programs of the nonprofits recently reviewed by FHA. FHA's second concern is that the sales price is often increased so that the seller's net proceeds are not diminished. This increases FHA's risk that it will not recover the full amount owed if forced to acquire and resell a home purchased by a participating borrower who then defaults on the loan.

The proposed rule generally permits a mortgagor's minimum investment to come from gifts from charitable organizations and other non-profit organizations, if HUD has approved the organizations as sources of gifts. Despite HUD's approval, an organization's gift may not be used for the mortgagor's minimum investment if the organization receives from the seller of the property at any time, directly or indirectly, either the gift funds, or other consideration or reimbursement for making the gift, including service fees. This prohibition would apply to sales of existing homes by private sellers as well as sales by builders, developers, etc., involved in new construction, or any party with an identity of interest with them. HUD would not allow any form of downpayment assistance in any of its programs if those funds are derived, partially or in whole, in any manner from sellers of the property being purchased with the assistance.

The proposed rule is intended to prevent a seller from providing funds to an organization as a quid pro quo for that organization's downpayment assistance for purchases of one or more homes from the seller. The proposed rule is not intended to preclude sellers such as builders from contributing to charitable and other nonprofit

organizations that provide downpayment assistance unrelated to properties sold by the seller or that otherwise further affordable housing.

Proposed Non-Substantive Redrafting of § 203.19

The current § 203.19, entitled "Mortgagor's minimum investment", is a combination of section 203(b)(9) of the National Housing Act (as it existed before the 1996 amendment) and additional regulatory policy in two areas. First, § 203.19(a) includes a \$200 minimum investment in two cases where section 203(b)(9) does not apply, due either to an express exclusion (for veterans) or an implicit exclusion (for disaster victims receiving a 100 percent mortgage under section 203(h) of the National Housing Act and § 203.18(e) of the regulations). Second, § 203.19(b) provides detailed guidance regarding the type of loan for cases (other than family member loans) where section 203(b)(9) expressly permits loans for the mortgagor's minimum investment. Regarding loans, § 203.19 does not currently recognize either family member loans or loans under State or local housing assistance programs (impliedly permitted by section 528 of the National Housing Act) although both forms of loans are recognized in FHA's mortgage credit handbook. There is nothing regarding downpayment assistance in the form of gifts in the current § 203.19. Therefore, we have considered it preferable to redraft and update § 203.19, in a non-substantive manner, instead of simply adding a new substantive discussion of restrictions for a particular type of gift.

As redrafted, § 203.19 has the following organization. Paragraph (a) requires a mortgagor to have the funds needed to complete the transaction (payment of purchase price and settlement costs) in addition to the funds provided by the insured mortgage itself. This basic policy was previously stated only in a handbook rather than a regulation, but it is a basic requirement of mortgage lending and does not represent a new substantive policy.

Paragraph (b) corresponds to the current § 203.19(a)(1) and the first part of section 203(b)(9) of the National Housing Act by stating the basic rule for a 3 percent mortgagor cash investment. The statute and the current regulation give HUD the discretion to require more than 3 percent, but it is no longer necessary to reserve this discretion in regulations. In practice, HUD has not demanded more than 3 percent except as needed to satisfy the basic requirement for cash sufficient to close the transaction (as stated in proposed

new paragraph (a)). Both the statute and the current regulation except from the 3 percent requirement for veterans (who can qualify for 100 percent mortgage financing for a \$ 25,000 loan under section 203(b)(2) of the Act) and disaster victims (who can qualify for 100 percent mortgage financing under section 203(h) of the National Housing Act). However, the current § 203.19(a)(2) imposes a \$200 minimum cash investment requirement for those mortgagors. That \$ 200 requirement is no longer meaningful in relation to vast increases in home values and mortgage amounts since the \$200 requirement was adopted, and HUD proposes to delete it from the regulations in the interests of simplifying mortgage processing.

Paragraph (c) of the proposed rule would state what has long been a basic HUD policy: the mortgagor's required funds should not come from the seller of the property. This is necessary to achieve meaningful application of statutory loan-to-value requirements. Otherwise, there could be a tendency for sellers to advance funds for closing costs while inflating the purchase price to recoup the costs, with a higher mortgage amount being based on the inflated price. Using the lesser of appraised price or purchase price to determine mortgage amount can control this tendency to a degree, but additional measures are prudent. On the other hand, HUD has recognized local market practices in which sellers customarily agree to pay some of the buyer's closing costs. Beginning in the mid-1980's, HUD's administrative policies reflected in Mortgagee Letters and handbooks have permitted some seller contributions, consistent with local market practices that would be reflected in local appraisal practices, but never more than 6 percent of the purchase price. Proposed paragraph (c) would permit HUD to continue this administrative policy and make any needed adjustment without rulemaking, as long as the seller does not ever provide the statutory 3 percent mortgagor's cash investment. Funds from the seller would be broadly defined as any funds derived directly or indirectly from any gift or loan made by the seller or any party with an identity of interest with the seller.

Paragraph (d) states the general policy that funds from loans or gifts may not be used for any part of the mortgagor's minimum investment, unless otherwise provided in the rule. Paragraph (e), like current § 203.19(b), is intended to identify certain loan sources authorized by statute. The paragraph states clearly HUD's historical understanding of the Congressional intent behind section

203(b)(9) of the National Housing Act: loans are a forbidden source of the 3 percent minimum investment unless a statute provides otherwise, explicitly or implicitly. Paragraph (e) includes certain statutory authorizations that HUD relies on but which are currently not stated or referenced in regulations (family loans and government loan programs). It also handles by general reference, instead of the more specific language in current § 203.19(b), certain little-used or unused loan sources authorized by section 203(b)(9) of the National Housing Act (e.g., HOPE 3).

Although paragraph (e) only restricts the use of loans for the 3 percent minimum cash investment and does not apply to the rest of the required investment, readers should note that § 203.32 contains restrictions on secondary financing that is unsecured or secured by the home. Paragraph (e) would not supersede anything in § 203.32. Paragraph (e) omits the detail regarding the acceptable form of loan that currently appears in § 203.19(b), because these are matters more suitable for a handbook.

Finally, paragraph (f) contains the new substantive policy proposal regarding gifts discussed above, while also setting forth other acceptable gift sources permitted by current policy.

Findings and Certifications

Environmental Review

A Finding of No Significant Impact is not required for this proposed rule because it is covered by the exclusion in 24 CFR 50.19(b)(6).

Regulatory Flexibility Act

The Secretary, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)), has reviewed this proposed rule before publication and by approving it certifies that this proposed rule is not anticipated to have a significant economic impact on a substantial number of small entities. The primary purpose of this rule, as noted in the preamble, is to establish standards regarding the use of gifts by charitable or other nonprofit organizations as a source of an FHA's mortgagor's investment in the mortgaged property. Specifically, the standards would provide that gifts could not be made from funds that the organization received, directly or indirectly, from the seller of the property. While HUD recognizes that many nonprofit or charitable organizations may be small entities, HUD does not believe that this rule would have a significant economic impact on a substantial number of small entities. HUD's proposed rule does not

preclude gifts from charitable or other nonprofit organizations. This proposed rule only precludes these gifts if these organizations receive from the seller of the property at any time, directly or indirectly, either the gift funds, or other consideration or reimbursement for making the gift, including service fees. The purpose of this restriction is to prevent a seller from providing funds to an organization as a quid pro quo for that organization's downpayment assistance for purchase of one or more homes of the seller.

While this restriction is an important one to place on the use of gifts as a source of downpayment, HUD believes that few entities, large or small, would be affected by this restriction. Nevertheless, HUD is sensitive to the fact that uniform application of requirements on entities of differing sizes often places a disproportionate burden on small entities. Therefore, small entities are specifically invited to comment on whether this proposed rule will significantly affect them, and to make any recommendations on alternatives for compliance the requirements of this rule. Comments should be submitted in accordance with the instructions in the **DATES** and **ADDRESSES** sections in the preamble of this proposed rule.

Executive Order 12612, Federalism

The General Counsel, as the Designated Official under section 6(a) of Executive Order 12612, Federalism, has determined that this proposed rule would not have "federalism implications" because it does not have substantial direct effects on the States (including their political subdivisions), or on the distribution of power and responsibilities among the various levels of government. This proposed rule solely addresses requirements under HUD's FHA mortgage insurance programs.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995, Pub.L. 104-4, established requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments and the private sector. This proposed rule does not impose any Federal mandates on any State, local, or tribal governments or the private sector within the meaning of Unfunded Mandates Reform Act of 1995.

Catalog of Federal Domestic Assistance

The Catalog of Federal Domestic Assistance Number for the principal FHA single family mortgage insurance is 14.117. This proposed rule would also apply through cross-referencing to FHA mortgage insurance for condominium units (14.133), and other smaller single family programs.

List of Subjects in 24 CFR Part 203

Loan programs—housing and community development, Mortgage insurance, Reporting and recordkeeping requirements.

Accordingly, the Department proposes to amend 24 CFR part 203 as follows:

PART 203—SINGLE FAMILY MORTGAGE INSURANCE

1. The authority citation for part 203 continues to read:

Authority: 12 U.S.C. 1709, 1710, 1715b, 1715u; 42 U.S.C. 3535(d).

2. Section 203.19 is revised to read as follows:

§ 203.19 Mortgagor's investment in the property.

(a) *Required funds.* The mortgagor must have available funds equal to the difference between:

(1) The sum of the purchase price of the home and settlement costs acceptable to the Secretary; and

(2) The amount of the insured mortgage.

(b) *Minimum cash investment.* The required funds under paragraph (a) of this section must include an investment in the property by the mortgagor, in cash or cash equivalent, equal to at least 3 percent of the cost of acquisition as determined by the Secretary, unless the mortgagor is:

(1) A veteran meeting the requirements of § 203.18(a)(3); or

(2) A disaster victim meeting the requirements of § 203.18(e).

(c) *Restrictions on seller funding.*

None of the required funds under paragraph (a) of this section may be provided by the seller, except as approved by the Secretary, notwithstanding paragraphs (e) and (f) of this section. For purposes of this paragraph and paragraph (f), funds are provided by the seller if they are derived directly or indirectly from any gift, loan or other payment, including a service charge, made by the seller or by any party with an identity of interest with the seller.

(d) *Gifts and loans usually prohibited for minimum cash investment.* A

mortgagor may not use funds for any part of the minimum cash investment under paragraph (b) of this section if the funds were obtained through a gift or a loan from any person, except as provided in paragraphs (e) and (f) of this section.

(e) *Permissible sources of loans.* (1) *Statutory authorization needed.* A statute must authorize a loan as a source of the mortgagor's minimum cash investment under paragraph (b) of this section. The authority may be explicit or implicit.

(2) *Examples.* The following loans are authorized (explicitly or implicitly) by statute as a source for the minimum investment:

(i) A loan from a family member, a loan to a mortgagor who is at least 60 years old when the mortgage is accepted for insurance, or a loan that is otherwise expressly authorized by section 203(b)(9) of the National Housing Act;

(ii) A loan made by, or insured by, a State or local government agency or instrumentality under terms and conditions approved by the Secretary; and

(iii) A Federal disaster relief loan.

(f) *Permissible sources of gifts.* (1) *General.* The following are permissible sources of gifts or grants used for the mortgagor's minimum cash investment under paragraph (b) of this section:

(i) Family members and governmental agencies and instrumentalities that may make loans under paragraphs (e)(2)(i) and (ii) of this section;

(ii) An employer or labor union of the mortgagor;

(iii) Charitable organizations or other nonprofit organizations approved by the Secretary as a source of gifts, subject to paragraph (2) of this section;

(iv) Disaster relief grants; and

(v) Other sources approved by the Secretary.

(2) *Charitable organization and other nonprofit organization.* A gift from a charitable organization or other nonprofit organization may not be used for the minimum investment if the organization receives from the seller at any time, directly or indirectly, either the gift funds, or other consideration or reimbursement for making the gift, including service fees.

Dated: August 23, 1999.

William C. Apgar,

Assistant Secretary for Housing-Federal Housing Commissioner.

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