MEMORANDUM FOR: John J. Coonts, Director, Office of Insured Single Family Housing, HSI

FROM: John J. Daly, Associate General Counsel, Office of Insured Housing, CI

SUBJECT: 24 CFR 203.42 as Applied to Non-Profit Organizations and Section 203(k) Escrow Commitment Procedures

Your memorandum dated March 22, 1996 requested advice regarding the impact of the word "rental" in 24 CFR 203.42 when the mortgagor falls into the category of "eligible non-occupant mortgagor" as defined in 24 CFR 203.18(f)(3).

The "rule of seven" or "seven-unit limitation" is stated in 24 CFR 203.42(a) as follows:

A mortgage on property upon which there is a dwelling to be rented by the mortgagor shall not be eligible for insurance if the property is a part of, or adjacent or contiguous to, a project, subdivision or group of similar rental properties in which the mortgagor has a financial interest in eight or more dwelling units. [Emphasis added.]

Frequently section 203(k) mortgages are excluded from the rule of seven by 24 CFR 203.42(b), which excludes such mortgages when they are to be used for rehabilitation of property in an area targeted for redevelopment by a State or local government that has submitted a plan to HUD that describes the redevelopment program. This memorandum does not address mortgages that fall within the exclusion.

The rule of seven is designed to prevent insurance of a mortgage under FHA single family programs if a mortgaged property is related, financially and by location, to seven or more other similar rental units that, collectively, could reasonably be viewed as a multifamily project. The rule does not affect owner-occupied one-family residences. It can limit the eligibility of owner-occupied buildings with two-to four-family residences and properties of any size that are not owner-occupied.

Section 203(g) of the National Housing Act ("NHA") provides, subject to certain exceptions, that the Secretary may insure a mortgage for a building for one-to-four families only if the mortgagor is to occupy the building as his or her principal residence or as a secondary residence, as determined by the Secretary. Section 203(g)(2) lists six situations where the
property can qualify for mortgage insurance even if it is not occupied by the mortgagor. These situations are described as involving "eligible non-occupant mortgagors" in the implementing regulations, 24 CFR 203.18(f)(3). Your inquiry involves two of these situations.

The first "eligible non-occupant mortgagor" circumstance that we will discuss in this memorandum is a non-profit organization that can qualify as a mortgagor under section 203(g)(2)(B) of the NHA because it is exempt from Federal income taxation and intends to sell or lease the mortgaged property to low or moderate-income persons, as determined by the Secretary. Your memorandum states your view that section 203(g) clearly does not consider these non-profits to be owner-occupants. We agree; otherwise, there would be no need to deal with non-profits in the section 203(g)(2) list of exceptions. You further indicate that the fact that non-profits may obtain the same level of financing as owner-occupants does not absolve the non-profits from the limitations of section 203.42; i.e., non-profits need not be treated the same as owner-occupant mortgagors for purposes of all requirements. We will discuss this issue in detail below.

The second "eligible non-occupant mortgagor" circumstance that we will discuss is an investor mortgagor who will purchase and rehabilitate a property with a rehabilitation loan insured under section 203(k) of the NHA.

Eligible non-profit organization (non-section 203(k))

HUD has informed mortgagees that local HUD Offices must determine the eligibility of non-profit organizations that will serve as mortgagors; see HUD Handbook 4155.1, REV. 4 CHG. 1., paragraphs 1-5A and 2-17. Once approved, however, a non-profit will qualify as a mortgagor for a particular mortgage only if—in addition to being determined creditworthy by the mortgagee—the non-profit "intends" to sell or lease the mortgaged property to be eligible for an insured mortgage. In order for the mortgagee to determine that this test is met, and to make the appropriate certification to HUD that the mortgagor is eligible, the mortgagee should obtain some creditable evidence of the mortgagor's intentions. HUD has not provided any written instructions to mortgagees on this point.

The concept of "rental" property occurs twice in section 203.42. That rule only applies if the property to be mortgaged may fairly be considered a property "to be rented by the mortgagor" within the meaning of section 203.42. If this test is met, then section 203.42 restricts the number of nearby "similar rental properties" in which the mortgagor may have a financial interest. Regarding the "to be rented" test, we conclude that this language is susceptible to more than one interpretation and that Housing has the option to choose the interpretation that best serves the objectives of section 203.42. There are two main approaches to applying the rule.

The first approach would treat mortgaged property as
property to be rented only in the presence of some positive indicator that rental will occur. For example, you could decide to adopt a policy that applied section 203.42 only to property that is actually rented at the time the property is acquired by the mortgagor, with the possible exclusion of property for which there is reason to believe that the rental status will end within a limited period specified by HUD (such as to allow for eviction proceedings). A related approach would also consider a vacant dwelling as one "to be rented" whenever the mortgagor states a clear intention to rent the property once acquired.

The other general approach that we find permissible under section 203.42 would treat all property owned by a non-profit as property to be rented in the absence of convincing evidence that the property will not be rented. A property that might be rented would be included. HUD could permit a mortgagee to rely on a statement by the mortgagor that it intends to sell the property to an eligible purchaser without any intervening rental period. We believe HUD could also regard all property purchased by a non-profit mortgagor with an FHA-insured mortgage as property to be rented regardless of the non-profit mortgagor's statement of intentions, in the absence of convincing evidence that the mortgagor is legally obligated to resell the property.

In our view, the latter approach could be justified as a reasonable implementation of section 203.42 because the law does not require that a non-profit mortgagor intend to sell the property in order to qualify for mortgage insurance. HUD does not require a mortgagee to obtain evidence of any binding commitment that a non-profit mortgagor will sell rather than rent. Thus, every non-profit mortgagor could potentially rent rather than sell, or rent for a period before selling, without violating any HUD program requirements. A non-profit mortgagor might also purchase with a good faith intention of reselling but later determine to retain the property for rental. Because HUD and the mortgagee will have no reliable means of distinguishing in advance the properties which actually will be rented from those that will not, HUD could justify treating all cases with non-profit mortgagees as ones where the property is to be rented (absent legal obligation to sell) in order to fully achieve the objectives of section 203.42.

After Housing determines the criteria that will used to identify properties to be rented, thus causing section 203.42 to apply, the next question would be which other units in proximity to the property being purchased should be counted toward the seven-unit limitation. Section 203.42 would restrict the non-profit mortgagor to a financial interest in no more than seven "similar rental properties." A consistent approach would be to count toward the seven-unit limitation other units which the non-profit mortgagor holds under circumstances similar to those that caused the property to be acquired to be viewed as property to be rented. Thus, if current actual rental is necessary to trigger the rule of seven, other units should be counted toward the seven-unit
limitation only if actually rented or on the rental market. If all units purchased by a non-profit without legal obligation to resell trigger the rule of seven, regardless of the purchaser's future intentions regarding the property, any other units of the purchaser count against the seven-unit limitation.

When Housing determines which of the possible applications of section 203.42(a) represent the desired Housing policy, paragraph 3-10 of HUD Handbook 4155.1 REV-4 CHG 1 should be revised if necessary to reflect the policy accurately. Currently, that paragraph appears to treat all mortgagors other than owner-occupant mortgagors--including non-profit mortgagors--as triggering section 203.42 in all situations.

Section 203(k) escrow commitment cases (including non-profits)

Any public, private for-profit, or non-profit mortgagor may qualify for a section 203(k) mortgage even though it will not be an occupant of the property. HUD has adopted a regulatory policy that limits the mortgage amount for these mortgagors to 85 percent of the sum of the as-is property value and the estimated cost of rehabilitation unless the mortgagee follows the procedure known as "escrow commitment" as authorized by 24 CFR section 203.50(k). Under the escrow commitment procedure, the investor mortgage may be for an amount not exceeding the maximum mortgage amount available to an owner-occupant mortgagor, but the excess over the 85 percent mortgage limit ordinarily applicable to section 203(k) investor mortgagors must be escrowed. Section 203.50(k) requires the investor mortgagor to certify to the following:

(1) Before a due date approved by HUD (currently 18 months after the mortgage is executed, according to paragraph 1-10 of HUD Handbook 4240.4 REV-2), the mortgagor will not rent (except for a 30-60 day term), sell (unless the mortgage is paid in full) or occupy the property, unless HUD approves;

(2) If the property is not sold to an eligible owner-occupant before the due date (e.g., the end of the 18 months), all escrowed amounts will be applied on the due date to reduce the outstanding mortgage balance; and

(3) Any escrowed funds not applied to the mortgage balance shall be deducted from insurance benefits if an insurance claim is filed.

Short-term rentals are expressly permitted by this certification. In addition, we do not think that the mortgagor is legally precluded from deciding to enter into longer term rentals before the 18-month period has expired if it requests the holder of the escrowed funds to apply the funds to the mortgage balance. The mortgagee's certification that funds will not be held in escrow longer than 18 months is not the equivalent of a certification that funds will always be held in escrow for the full 18 months, in lieu of application to the mortgage balance,
if no sale has occurred. The mortgagor may also rent the property if the escrowed funds are applied to the mortgage balance at the end of the 18 months.

The options for applying the rule of seven for escrow commitment cases are similar to those discussed above for non-section 203(k) non-profit mortgagors. It is permissible for Housing to adopt approaches ranging from a focus on actual rentals to an approach that treats all section 203(k) properties without owner-occupant mortgagors as properties to be rented within the meaning of section 203.42.

To the extent needed to reflect your desired policy, we suggest revision of the first sentence of paragraph 4-6, HUD Handbook 4240.2 REV-2, which currently states: "A Borrower that purchases property for rental purposes rather than rehabilitation and sale, will be subject to the 7-unit limitation in 24 CFR 203.42." The ambiguous phrase "for rental purposes" could be clarified. The "Escrow Commitment Certification" that is Attachment 7 to Mortgagee Letter 95-40 requires each mortgagor using the escrow commitment procedure to certify: "I understand the seven (7) unit limitation rule will apply." If Housing will permit some exceptions instead of treating all escrow commitment cases as triggering section 203.42, this certification should be revised.

We would appreciate being informed of the Office of Housing policy decisions make regarding application of section 203.42.