CHAPTER 28. SPECIAL ESCROWS

SECTION 1. CHAPTER OVERVIEW AND PURPOSE

28-1. Introduction and General Use. From time to time in the servicing life of a HUD Insured or formerly coinsured mortgage, an event may occur in which Loan Management Staff and/or owners may see a need for establishing an escrow account. Since the use of escrow accounts is not unique to one segment of the Department, this chapter is only designed to present the role Housing Management will have in relation to these types of accounts. For the sake of clarity, this chapter will discuss escrows in two broad categories:

a. Escrows established prior to final endorsement. These escrows, also known as Pre-final endorsement escrows, will be the responsibility of Housing Management to monitor if they are in existence after final endorsement occurs. Housing Management has no authority to set standards or requirements for these types of escrows or establish these types of escrows, as this is done in Housing Development prior to final endorsement. In relation to this type of escrow, Housing Management will simply be responsible for monitoring, approving releases, extensions and terminations in the post-final endorsement stage. Loan Management Staff should assure the required inspections are completed and approved by appropriate HUD staff prior to releasing escrow funds. In dealing with pre-final endorsement escrows this is of particular concern when there are latent defects on a physical problem which Development is tracking. Loan Management Staff should not approve an escrow release when this type of problem exists, until the Architecture and Engineering Branch Staff have completed and approved the appropriate inspection.

b. Escrows established after final endorsement. An escrow in this category is established by Housing Management, thus, the standards, financial requirements, monitoring methods, including extensions and terminations, may vary from the Pre-final endorsement escrows because the structure is established by Housing Management based on the use of the escrow. For the purpose of this chapter, these escrows will be broadly titled Post-final endorsement escrows. The Office of Multifamily Housing Management currently approves three types of deposit as legitimate escrows for post final endorsement escrows: (1) Cash; (2) Letters of Credit (See paragraph 28-7 for further guidance); and (3) United States Securities issued by a Federal Agency. This type of escrow account should be held by the mortgagee (or other mutually agreed upon depository) and funds should not be released without written approval from HUD.

NOTE: Concerning escrows established by Property Disposition at the time of closing, Loan Management Staff should treat these escrows in the same manner as pre-final endorsement escrows once the property enters the Loan Management inventory after being sold. For additional guidance on these types of escrows reference should be made to Housing Notices 91-84 and 90-62.

Many types of escrows in these two categories are discussed in other chapters throughout Handbook 4350.1. These accounts will simply be referenced in this chapter, as opposed to fully discussed.

SECTION 2. PRE-FINAL ENDORSEMENT ESCROWS

28-2. Operating Deficit Escrows. While this escrow is initiated by Housing Development during the final endorsement phase of mortgage insurance, Housing Management is responsible for approving disbursements from this account. This account is normally funded utilizing the owner's (or sponsor's) funds to cover the operating deficit of up to 24 months or until the project is expected to reach sustaining occupancy. The purpose of this account is to fund any deficit created when operating income fails to meet operating expenses and debt service requirements. Once final endorsement occurs and amortization begins, regular escrow deposits to Reserve for Replacement, tax and insurance escrows are expected to continue as normal and should be funded from the operating deficit escrow if funds are not available from net operating income.

SECTION 3. POST-FINAL ENDORSEMENT ESCROWS

28-3. Repair Escrows. This type of escrow may be needed when the repair(s) involve a large sum of money to be paid in draws, such as an insurance draft (see Chapter 21, Page 21-22). A repair escrow may be needed in foreclosure processing (see Housing Notice 91-68 for further instructions), in relation to a Workout (Chapter 11, Page 11-17) or a Transfer of Physical Assets (Chapter 13, Page 13-12).

28-4. Escrow of the owner contribution. In some instances an owner's contribution may need to be escrowed to assure that the additional funds will be available for project use. This may be required of the buyer in a TPA (Chapter 13) or of the owner when funds are pledged as part of a Workout agreement (Chapter 11).

28-5. Escrow of a deed to the property. This is a tool which is used in rare instances in relation to TPAs and Workouts. Specific purposes for escrowing a deed of trust are outlined in Chapter 13, Page 13-95 and Chapter 11, Section 11-25(2), respectively.

SECTION 4. MONITORING ESCROWS

28-6. Monitoring Requirements. The Loan Management Branch should always be aware of what escrows are in existence and key dates which will require action by the Loan Management Staff should be realized well ahead of time. A system, either a manual card system or a computerized tracking system, should be developed to monitor these key dates so that Loan Management Staff will be notified with sufficient time (at least a month ahead of time, when possible) to take the necessary action. This system should identify expirations of Letters of Credit, termination dates for escrows, any required deposit dates as well as other dates which will be necessary to monitor in order to assure the escrow funds will be available when needed.

SECTION 5. LETTER OF CREDIT REQUIREMENTS FOR POST-FINAL ENDORSEMENT ESCROWS

28-7. The Letter of Credit (LOC). Although this is a legitimate type of escrow for post-final endorsement escrows, the LOC should normally only be utilized to provide funds when other methods such as cash or securities are unavailable. Because of the expense involved in obtaining a LOC, the concern about the continued strength of lending institutions in today's market, as well as the monitoring required by HUD staff to assure that the LOC remains viably negotiable, this instrument should be considered a means of last resort. Before accepting a LOC, the Field Counsel should review the instrument to assure it adheres to all legal requirements as well as with the guidelines stated below. When utilizing a LOC the following guidelines should be followed:

a. Strength of the Lending Institution. In recent years this has become a greater concern when accepting Letters of Credit due to the lack of stability in the lending industry. Before accepting a LOC drawn on a lending institution Loan Management Staff should assure that the issuer has a credit rating on it's long term obligations in one of the two highest categories established by a national rating agency (Standard and Poors, Moodys, etc), in addition to being a Federally Insured lending institution. If the bank has not been issued a credit rating by a national rating agency, then it must at least be in compliance with the risk-based capital guidelines established in Part 3 or Part 208 of Title 12, Chapter 1 of the Code of Federal Regulations which were in place at the time of the bank's charter. If Loan Management Staff questions the strength of a lending institution, they should consider consulting the Mortgage Credit Branch of Housing Development for assistance in assessing the institution. If additional information is needed to confirm the strength of a lending institution issuing a LOC, it will be the responsibility of the mortgagor requesting HUD to accept a LOC to provide the needed information for verification.

b. Location of the Issuer. The HUD Field Office should always consider the location of the issuer of the LOC. The issuer, or a branch subsidiary of it, should be in close proximity to the HUD Field Office with the authority to "call" the LOC since when a decision is made to call, the funds are usually needed immediately. If the calling agent is employed in the Regional Office, the institution, or its branch subsidiary, should normally be located in the same city as the Regional Office.

c. Relationship of the owner to the issuer of the LOC. Any letter of credit must be unconditional and irrevocable. It should not be dependent upon whether or not the owner fulfills any other obligations they may have to the issuer of the LOC. Loan Management Staff should evaluate, using available information, (i.e. project files and annual financial statements), the other obligations the owner has to the lending institution issuing the LOC. If the Loan Management Branch Chief feels that the LOC may not be secure based on the owners requirement to fulfill other obligations to the lender, the LOC should not be accepted. If there remains doubt concerning the impact that other financial conflicts of the owner might have on the LOC in question, they should consider seeking the assistance of the Mortgage Credit Branch for any information they may have concerning the owner.

d. Provisions, Terms and Amounts of the LOC. Once the lending institution and location have met the above guidelines, the Loan Management Staff must assure that the LOC itself will meet the need if it becomes necessary to "call" the obligation. As a rule, a LOC should have a term which runs at least 6 months beyond the date of the scheduled completion of repairs and should be established for up to 125% of the amount estimated to be required. An appropriate provision for extensions should be incorporated. A provision for reduction in the amount of LOC for staged work completed or work in progress, may be acceptable.

LOCs are usually placed in the care of a trustee or fiduciary. Because they are negotiable instruments, special care should be taken to assure safekeeping. In many cases, the trustee or

fiduciary will take charge of renewing the LOC, if needed. It is important that a member of Loan Management Staff as well as the Field Counsel review the LOC prior to each renewal to assure accuracy in format as well as the amount, the term and the calling agent. If any of these items are incorrect when the letter is renewed, it may result in the lending institution's refusal to honor it at a later date. For example, if the calling agent is specified as the Field Office Manager and the Field Office has since incorporated into a co-located office with the Region, the lending institution may refuse to honor the LOC based on the fact the position of Field Office Manager does not exist. Unless the LOC is callable by the Secretary or his/her designee, the HUD position identified by the LOC should be checked to assure it is still current and accurate.

e. The Cost of a LOC. One of the disadvantages of utilizing the Letter of Credit as an escrow funding mechanism is the cost involved in securing a Letter of Credit. This cost must be paid by the owner and is not an allowable project expense.

f. Control and Follow-up. The Field Office Manager is responsible for maintaining control over all LOCs for projects within the Field Office jurisdiction. It is recommended that the Loan Management Branch develop an inventory of all existing LOCS. This inventory should identify the project, issuing entity, terms, call date, authority to call and any other pertinent information for each LOC. If LOCs are held by a trustee, an arrangement should be made to keep the Loan Management Branch Chief informed when a LOC requires renewal or will expire. It is vitally important that expirations, extensions and draws be carefully monitored and controlled.