

Mortgage Insurance

Legal Opinion: GHM-0082

Index: 4.200

Subject: Mortgage Insurance

March 29, 1993

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New York, NY 10271

Dear Mr. Viets:

On behalf of Secretary Cisneros, thank you for your letter of February 19, 1993, concerning the Escondido Retirement Service Center ("Project") (FHA Project No. 129-35082) and your claim that the Bank of New York ("Bank") did not receive mortgage insurance benefits in excess of that which was due.

The mortgage loan for the Project was insured by the Department pursuant to Section 221(d)(4) of the National Housing Act (NHA), as amended. Funds for construction of the project were primarily provided through the issuance of \$11,705,000 of tax-exempt revenue bonds. As a condition for its mortgage insurance, the Department required the establishment of a "Debt Service Escrow", also known as an "Initial Operating Reserve", in the amount of \$508,190 to cover deficiencies during the initial period of operation of the Project.

At the initial endorsement of the Project, the Bank accepted from the mortgagor a letter of credit, issued by the Victoria Savings and Loan Association, in satisfaction of the escrow requirement established by the Department. The letter of credit had not been used for its intended purpose when the mortgagor defaulted on May 1, 1989, and a monetary default was declared by the Bank. Thereafter, the Bank elected to assign the mortgage loan to the Department in exchange for mortgage insurance benefits.

On June 28, 1989, the Federal Savings and Loan Insurance Corporation ("FSLIC") was appointed receiver of Victoria Savings and Loan Association, the issuer of the letter of credit. The Bank "drew upon" the letter of credit for the full amount of the letter of credit, i.e., \$508,190, but the Resolution Trust Corporation, as successor to FSLIC, refused to honor the draw request by the Bank and formally repudiated the letter of credit on December 27, 1989.

When the Bank's insurance claim was calculated by the Department, the amount of the letter of credit was not deducted from the Bank's mortgage insurance benefits although the letter of credit, or the cash equivalent, was retained by the Bank. This resulted in an overpayment of the Bank's mortgage insurance benefits and the Department's request for the return of these

funds. I have set forth below the basis upon which the Department's demand is predicated.

The regulations at 24 C.F.R. 221.540(a) provide for the mortgagor to deposit with the mortgagee monies to cover projected deficiencies during the initial period of operation of the project. Pursuant to 24 C.F.R. 221.540(e), the mortgagee "may accept, in lieu of a cash deposit required by 24 C.F.R. 221.540(a) an unconditional irrevocable letter of credit issued to the mortgagee by a banking institution." However, that regulation expressly provides that "if a demand under a letter of credit . . . is not immediately met, the mortgagee shall forthwith provide the cash equivalent to the undrawn balance under the letter of credit." This latter provision of the regulations makes clear that if the Bank chooses to accept a letter of credit in lieu of the cash deposit, the Bank bears the risk of loss if the letter of credit is not honored.

A mortgagee's insurance benefits for a loan insured under Section 221(d)(4) of the NHA, as amended, are calculated in accordance with the provisions of Subpart B of 24 C.F.R. Part 207. (See 24 C.F.R. 221.751(a).) When a mortgagee seeks insurance benefits, the regulations provide that any cash items held by the mortgagee for the account of the mortgagor, including "the amount of any undrawn balance under a letter of credit used in lieu of a cash deposit" shall be retained by the mortgagee or delivered to the Department in accordance with instructions issued by the Department. (See 24 C.F.R.

207.258(b)(5)(iv).) When this Department directs the mortgagee to retain the letter of credit (or a cash equivalent when a demand under the letter of credit has not been met), that sum is deducted from the mortgage insurance claim. (See 24 C.F.R. 207.259(b)(2)(iii).)

I would note that under this regulation, when the Department directs a mortgagee to deliver these cash items, the mortgagee is obligated to pay an amount of the cash equivalent to the undrawn balance of the letter of credit. The mortgagee does not assign the letter of credit.

When the Resolution Trust Corporation did not immediately honor the Bank's request to draw upon the letter of credit, it was incumbent upon the Bank to "provide the cash equivalent to the undrawn balance under the letter of credit." (See 24 C.F.R. 221.540(e).) Consequently, the Department should have deducted the cash equivalent of the undrawn balance of the letter of credit when calculating the Bank's insurance benefits. (See 24 C.F.R. 207.259(b)(2)(iii).) Therefore, the Department's demand for repayment of the \$508,190 plus interest is correct.

The Department does not provide a hearing on disputes concerning insurance claim amounts. I have asked Gerald Salzman, an attorney on my staff, to contact you concerning your request for a meeting.

Very sincerely yours,

John J. Daly  
Associate General Counsel  
Insured Housing and Finance