Lump Sum Drawdown Accounts - Collateralized Loan Agreements

May 22, 1991

MEMORANDUM FOR: Gertrude W. Jordan, Regional Administrator- Regional Housing Commissioner, 5S

ATTENTION: Harry I. Sharrott, Manager Detroit Office, 5.4S

FROM: Anna Kondratas, Assistant Secretary for Community Planning and Development, C

SUBJECT: Lump Sum Drawdown Accounts - Collateralized Loan Agreements

This is in response to your memorandum of February 11, 1991, requesting a determination as to whether it is permissible for the City of Battle Creek to continue to use collateralized loan agreements which were entered into under the provisions of Section 570.513 of the regulations.

Because the collateralized loan accounts in question were established by the use of deposits made under lump sum drawdown agreements, the collateralized accounts cannot be viewed as separate and distinct from the lump sum agreements. Therefore, no additional loans may be made under agreements which have expired.

Notice CPD-90-37, Lump Sum Drawdown Agreements for CDBG Entitlement Programs, issued August 20, 1990, provides guidance on the status of lump sum drawdown agreements and the treatment of existing lump sum agreements. Paragraph 4 on page 2 of this Notice states, in part, ". . .Deposited funds which have been obligated within the period in order to guarantee loans may remain on deposit after the end of the period provided that the amounts on deposit are in accordance with the terms of a lump sum agreement meeting CDBG requirements and in accordance with OMB Circular A-87 (the amount on deposit is reasonable in relationship to the amount of the loan and, in no case does the amount on deposit ever exceed the outstanding balance of the loan)." Because the collateralized accounts in question were used to guarantee loans made by financial institutions, this provision will apply. However, based on the limited amount of information provided, there is some question as to whether the amounts deposited exceeded the amounts that could reasonably be expected to be needed to cover actual defaults.

The grantee and financial institution may not have had experience with collateralized loan accounts such as these when the agreement was signed. Therefore, we should allow maximum latitude with regard to the amount of funds initially required to remain on deposit. However, as experience was gained, an adjustment should have been made to reflect actual loss experience. Since it is unclear if this occurred, we recommend the following:

1. Detroit Field Office Community Planning and Development (CPD) staff should review these accounts to determine if all deposited funds were obligated during the period of the lump sum

agreement to guarantee loans or if unobligated funds remained after the agreement period. If there were unobligated funds, they must be returned to the City's line- of-credit;

2. If funds have been obligated to guarantee loans, they may remain on deposit after the agreement has expired, but the allowable total for the collateralized loan account should be reviewed. An appropriate index for establishing the
amount of funds in the account would be the bank's ratio of expected losses to all loans outstanding. If no such default rate was used to determine the amount deposited in the account when it was established, it should be determined now based on the actual losses which were incurred while the program was in effect. If this part of the analysis shows that the amount of funds on deposit should be reduced, the agreement between the grantee and the financial institution should be reviewed to determine if the return of funds would constitute a breach of contract;

3. A procedure should be established to review these accounts on a periodic basis, e.g., annually, to determine if, based on repayments and defaults that have occurred, the amount of funds on deposit should be reduced by returning part of the deposit to the grantee's line-of-credit without a breach of contract; and

4. Interest earned on all funds determined to have been in excess of the amount required, excluding any that were generated by a qualified lump sum drawdown, must be returned to the Federal Government

Interest earned on funds that were drawn down in a lump sum in accordance with the regulations at 24 CFR 570.513 is considered program income and is not required to be returned to the Federal Government. This is also true for interest earned on collateralized accounts that were not in excess of expected losses. However, interest earned on any other funds is considered as having been earned on funds drawn in advance of need, and falls under the requirements of 24 CFR 570.506(a). These funds must be returned to the Federal Government.

Although the collateralized loan accounts discussed above cannot be used after termination of the lump sum drawdown agreement, a grantee could establish a program to guarantee rehabilitation loans on a loan-by-loan basis. However, if such a program is used, the grantee should be reminded that drawing funds from a line-of-credit before they are needed to cover actual default must be supported by adequate justification to demonstrate that no financial institutions will participate in the program and accept a payment guarantee without having funds on deposit. Further, if it is concluded that a drawdown in advance of default is justified, the amount deposited into a reserve account must be reasonable. In establishing such a program, the grantee should:

1. Negotiate with area lending institutions to determine if loans could be guaranteed (e.g., through an irrevocable letter of credit) without the need to deposit funds in a reserve account.

2. In the event it is concluded that funds must be deposited in advance of default, the City should establish a reasonable loss reserve amount for each loan. The level of funds maintained in a reserve account should take previous experience into consideration as a basis for determining

loss reserve amounts. The loss reserve amount and the methodology for determining such amount should be reviewed by HUD prior to the drawdown of funds from the line-of-credit.

3. The grantee should ensure that any collateralized reserve accounts bear at least the normal, usual and customary interest rates that would accrue to comparable accounts for the area.

If you have additional questions on this matter, please contact the Entitlement Communities Division.

cc: Linda Marston, SC