Deduction of Funds in GNMA-Related Escrow

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Subject: Deduction of Funds in GNMA-Related Escrow

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Re: The Ritz Plaza
Project No. 012-35620
New York, New York

Gentlemen:

This responds to your letters dated April 10, 1991, June 25, 1991, July 19, 1991 and September 10, 1991, concerning the issue of whether the Department is entitled to surcharge the insurance claim filed by Reinlein Lieser McGee ("RLM") with respect to the letters of credit drawn down by RLM which funded a GNMA-related escrow.

The Ritz Plaza (the "Project") was financed by a Section 221(d)(4) mortgage dated July 19, 1988, in the amount of $84,292,700. At initial endorsement RLM collected from Jason and Julia Carter (the "Sponsors") letters of credit ("Letters of Credit") in the total amount of 1.75% of the face amount of the Mortgage. The Letters of Credit were provided in order to fulfill the following condition of RLM's financing commitment to the mortgagor, S-C Associates, L.P. (the "Mortgagor"):

> "GNMA Certificate of Deposit. GNMA requires a Certificate of Deposit in the amount of 1-3/4% of the FHA Loan amount, to be maintained for a period extending three years subsequent to the date of issuance of the GNMA Project Loan Certificate. The Mortgagor shall provide a deposit in this sum at Initial Closing, in a form satisfactory to Lender and to be held in Lender's name during construction. At Final Endorsement, said deposit will be converted to a Certificate of Deposit in GNMA's name for the three-year period subsequent to the issuance of the Project Loan Certificate. Interest on the Certificate will be paid to the Mortgagor, provided no default has occurred in payments pursuant to the FHA Loan."

Prior to final endorsement the Mortgage went into default. RLM has drawn down the Letters of Credit. FHA has paid the final settlement on the insurance claim, but has reserved its determination as to whether a deduction should be made with respect to the Letters of Credit. Accordingly, the insurance

benefits paid were reduced by the amount of the Letters of Credit pending such determination.

At the outset it is important to make clear that Letters of Credit do not themselves constitute an escrow required by GNMA. Paragraph 16-5(b) of the GNMA I Mortgage Backed Securities Guide (the "GNMA Guide") provides that a certificate of deposit in the amount of 1.75 percent of the face amount of the pooled mortgage must be provided to GNMA at the time that Project Loan Securities ("PLCs") are issued; the certificate of deposit is intended to provide collateral for the lender-issuer's liabilities to GNMA for losses occurring during the three-year Indemnity Period following the issuance of the PLCs. The requirement that Letters of Credit be placed with RLM at initial endorsement to ensure that funds would be available to meet the GNMA requirement when the PLCs were issued was RLM's requirement, not GNMA's. (GNMA's 4% collateral requirement with respect to the issuance of construction loan securities was met through RLM's advance of mortgage proceeds in an amount exceeding the total principal amount of the securities by at least 4%, in accordance with Paragraph 17-5(b)(2) of the GNMA Guide.) Therefore, the instant case is distinguishable from any precedents or authority indicating that HUD would not deduct the amount of a "GNMA Indemnification Escrow" in calculating insurance benefits.

In your letters you analogize the status of RLM as lender-issuer with that of a bond trustee. You allude to a June 10, 1980, letter from John P. Kennedy to Kenneth G. Lore, in which Mr. Kennedy stated that funds collected by a trustee of a Section 103 tax-exempt construction financing issuance would not be deducted from insurance benefits. You state in your letters that the Letters of Credit were likewise for the benefit of securities holders, and you point out that the proceeds from the Letters of Credit were used to pay the securities holders in full once RLM obtained the partial settlement from HUD. We find that the situation described in the June 10, 1980 letter is distinguishable from the present case. Unlike bond holders, the GNMA securities holders are fully protected by the GNMA full faith and credit guarantee. It was RLM, and not the securities holders, that needed the assurance and protection of the Letters of Credit. Moreover, even if HUD were to accept the analogy between a bond trustee and a GNMA lender-issuer, the fact remains that the Letters of Credit were held by RLM in anticipation of its potential responsibilities under the PLC program, and not to fulfill any then-existing responsibilities as a lender-issuer.

You also cite in your letters a March 20, 1986, letter from Eliot C. Horowitz to Gerald D. Levine, Esq., which concluded that certain security devices required by GNMA would not result in a surcharge in insurance benefits. The letter's holding was based in part on the fact that GNMA is the sole party authorized to draw on the letter of credit (or certificate of deposit) and that

the security devices are delivered to GNMA and not held by the mortgagee. Once again, the situations addressed in that letter are clearly distinguishable from the instant matter. The Letters of Credit were not held by GNMA, and GNMA was not designated as a party entitled to draw on them.

We would like to point out that in a later letter we distinguished the security devices discussed in our March 20, 1986 letter from security devices held by the lender-issuer. The December 1, 1988 letter (copy enclosed) to Mr. Levine from Eliot C. Horowitz discussed cases in which the lender-issuer obtains a letter of credit from the mortgagor, and then has a separate letter of credit, with itself as the account party, issued to GNMA. If a mortgage default occurs and the lender-issuer obtains insurance benefits and pays the securities holders in full, GNMA will return the letter of credit which it holds to the lender-issuer. The lender-issuer, on the other hand, will draw down on the letter of credit that it obtained from the mortgagor. We stated that in this situation HUD was entitled to make a deduction in the amount of the mortgagor's letter of credit drawn down by the lender-issuer, since the purpose of that letter of credit was to protect the lender-issuer, not GNMA.

Our December 1, 1988 letter cited New York State Teachers' Retirement System v. HUD, 290 F. Supp. 346 (N.D.N.Y. 1968), in which the mortgagee collected from the mortgagor funds in the amount of one percent of the mortgage, under an agreement providing that in the event of default and assignment of the mortgage to FHA, the mortgagee would be entitled to retain the deposit. The court held that HUD was entitled to deduct the amount of the deposit from the insurance claim. See also State Street Bank & Trust Co. v. United States, 657 F.2d 1199 (Ct. Cl. 1981). Likewise, in the instant case it appears that RLM drew down on the Letters of Credit to compensate itself for losses not reimbursed through the insurance claims process.

In your letters you stress that the Letters of Credit were drawn on the account of the Sponsors and not the Mortgagor, and you cite previous letters from this Office which draw a distinction between funds provided by sponsors and those provided by the mortgagor. In his June 10, 1980 letter John Kennedy noted that the funds in question were deposited by the sponsor and not the mortgagor. He concluded that no deduction was warranted, because the funds were held not by the mortgagee but by the trustee, and would not be held for the account of the mortgagor, but "for the benefit of the holders of the notes." Thus, the distinction drawn by Mr. Kennedy was whether the funds were intended to benefit the mortgagor or the securities holders. As we explained above, in the present case we regard the Letters of Credit as providing assurance and protection to RLM, and not the securities holders.

Finally, in our March 20, 1986 letter, we again noted that

the security devices in question were drawn on the account of an affiliate or general partner of the mortgagor, and not the mortgagor itself, and thus were not "for the account of the mortgagor." However, unlike the security devices examined in that letter, which existed for the protection of GNMA, the Letters of Credit constitute the equivalent of "cash held by the mortgagee or its agents or to which it is entitled...." 24 CFR 207.258(b)(5)(ii). Clearly, the Letters of Credit were held by RLM, and since RLM has drawn down the Letters of Credit to help cover its losses, it appears that the Letters of Credit were funds to which RLM was entitled.

For the reasons stated above we have concluded that HUD is entitled to impose a surcharge in the amount of the Letters of Credit. We are so instructing our Office of Mortgage Insurance Accounting and Servicing, and thus no supplemental insurance benefits claim will be paid to RLM.

Very sincerely yours,

John J. Daly
Associate General Counsel
Insured Housing and Finance

Enclosure