CHAPTER 10: LEVERAGED LOANS

SECTION 1: UNDERSTANDING LEVERAGED LOANS

10.1 OVERVIEW

A leveraged loan is an Agency loan that is supplemented by a loan or grant from another funding source that is provided at the same time the Agency loan is closed. Leveraging reduces the amount the Agency must provide to help a borrower obtain adequate housing. The additional funding source may be a private lender that provides home financing at market rates, or a State or local government, or a nonprofit organization that provides subsidized loans or grants. This chapter provides basic information about leveraging and describes the modifications to regular loan processing procedures that are made when a loan is to be leveraged.

A. Advantages of Leveraged Loans

Leveraged loans offer advantages to both the Agency and borrowers. By combining its resources with those of other lenders, the Agency can assist more borrowers. For this reason, loans that will leverage other sources of funding receive a processing priority, as described in Paragraph 3.13 B.

Who Can Be a Participating Lender?

"Lender," as it is used in this chapter, refers to an organization that provides loans or grants for housing, including private lenders, State and local governments, and nonprofit organizations.

For some borrowers, purchasing a home through a leveraged loan will be the first opportunity to establish a relationship with a private lender. For other very low-income applicants, combining the Agency loan with a grant or low-interest loan from another subsidy program may be the only way to make homeownership possible. Leveraging is especially encouraged in the case of assumptions on new rates and terms, since the borrower may be able to obtain a non-Agency loan for purchase costs above the outstanding balance to be assumed. Attachment 10-A provides an example of an Agency loan leveraged with private financing.

B. Two Separate Financial Agreements

When a loan is leveraged, each lender enters into a separate financial agreement with the borrower. The combined resources that are provided enable the borrower to purchase a home. Although each lender remains responsible for final underwriting decisions for its loan, the application and underwriting processes should be streamlined whenever possible to avoid duplication of effort and extra burden on the applicant.

10.2 SOURCE OF LEVERAGED FUNDS

Agency funds may be leveraged by funds from a variety of sources. One of the challenges for the Loan Originator will be to understand the implications for the applicant and the Agency of the requirements that may be imposed by these sources.

A. Market Rate Financing

Private lenders generally have a variety of loan products that are tailored to fit specific circumstances, for example, different products for new purchases, refinancing, and home improvement loans. Some lenders may have specific products for first-time home buyers. The terms that lenders offer may vary depending upon the purpose and amount of the loan. The agency will accept either a long-term fixed rate mortgage of 30 years or a 15 year balloon payment with a 30 year amortization. The Agency will not accept an adjusted rate mortgage (ARM). Buydowns are acceptable, however the maximum reduction which may be considered and utilized for repayment ability calculations is 2 percent below the note rate, even though the actual buydown may be for more. Loan Originators may need to work with the lender and the applicant to identify an appropriate loan product that meets lender and Agency requirements.

B. Other Subsidized Financing

Although there are many variations in the specifics, the subsidized funds that can leverage Agency funds will generally come in one of the forms described below.

- **Grants without long-term restrictions.** Some grants are provided with no restrictions, as long as the applicant is eligible and the funds will be used for an eligible purpose.

- **Forgivable loans.** Some sources provide funds that require repayment only if the home buyer fails to comply with program requirements or restrictions. For example, a funding source may provide funds for a down payment or rehabilitation that need not be repaid if the home buyer remains in the property for a specified period of time. The funds are generally provided as a loan to permit the funding agency to record the circumstances under which repayment is required.

- **Deferred payment loans.** Deferred payment loans may be used to provide funds that are repaid only upon transfer of the property or as a balloon payment at the end of a specified period. These funding arrangements often include a provision for the funding source to share any appreciation that occurs with the home buyer.

- **Amortizing low interest loans.** In many areas, low-interest loans are offered by State and local government agencies. These loans require repayment on a monthly basis and may include provisions for the funding source to share in any appreciation.

Grants, forgivable loans, deferred payment loans, and any other nonamortizing loans are not considered in calculating the monthly principal, interest, taxes, and insurance (PITI) or total debt (TD) ratios. However, all other lender's payments must be included in the PITI. In those cases where there is a soft, silent or forgivable subordinate affordable housing product for the purpose of closing costs, the total debt may exceed the market value by 5 percent. The Agency's ability to recapture subsidy funds may be affected by the provisions of these loans. Agency loans should be subordinated only in the case of an amortizing loan.

10.3 KEY DIFFERENCES IN POLICIES AND PROCEDURES

This paragraph highlights major policy and procedural differences between leveraged loans and loans funded solely by the Agency. Detailed processing guidance for originating leveraged loans is provided in Section 2 of this chapter.

A. Eligible Loans and Grants

Cash contributions by the borrower, gifts from individuals, and donations of land do not count as leveraged amounts. Subsequent loans cannot be leveraged unless they are used in conjunction with assumptions on new rates and terms.

Generally, the Agency will not consider leveraging arrangements with market-rate financing sources in which either the lender's loan or the Agency's loan amount is less than 20 percent of the combined transaction amount. However:

- Private financing in any amount may leverage an Agency loan connected with an assumption on new rates and terms;

- Subsidized financing in any amount may leverage an Agency loan; and

- The State Director may approve leveraging arrangements that do not meet these criteria, when it is in the best interest of the Government.

B. Lien Position

To encourage participation by other lenders, the Agency generally will subordinate its lien position, even when the Agency provides the majority of the funds. However, liens related to other subsidized funds provided in the form of grants and nonamortizing loans, such as deferred payment or forgivable loan, must be subordinated to the Agency's loan. In those cases where there is a soft, silent or forgivable lien, the total debt may exceed the market value by 5%.

C. Payment Assistance Calculation

Payment assistance is calculated using the Equivalent Interest Rate (EIR) without consideration of a floor payment. UniFi automatically makes this adjustment when a leveraged loan is identified.

D. Availability of Mortgage Credit Certificates (MCC)

Under current tax law some State and local issuers of mortgage bonds may issue MCC to provide a Federal income tax credit to assist low-income home buyers and home owners. The credit permits an eligible household to claim a specific percentage of the annual interest paid on a mortgage as a tax credit rather than a deduction. If an applicant will receive the credit, the benefit of the credit may be considered when completing the “grossing up” income calculation described in Paragraph 7.16 A.4. MCCs are issued through private lenders.

E. Origination

Many processing steps can be conducted by the participating lender, rather than Agency staff. For example, the Agency may accept application and income information provided by the lender and permit the participating lender to conduct appraisals and inspections. However, even when the Agency relies on the work of the participating lender, it retains final underwriting and loan approval responsibility for the Agency loan. Responsibility for compliance with environmental requirements remains with the Agency, although the lender may be asked to assist in collecting needed environmental information. Section 2 of this chapter provides detailed processing guidance for originating leveraged loans.

F. Servicing

Leveraged loans are eligible for the same servicing actions as any other Section 502 loan. However, servicing strategies may be different because of the Agency's lien position and the need to coordinate servicing strategies with the participating lender.

1. Tax Service Fee (Tax and Insurance Escrow)

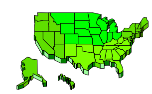
The Agency will collect a tax service fee on all leveraged loans. When necessary, the Agency may make advances to pay taxes or insurance premiums.

The Agency is customarily in a subordinate lien position with the largest portion of the loan amortized for the longer term, and is at more risk than the other lender. An exception to this may be agreed to with the prior lien holder when the tax service vendor agrees in writing to cover both the Agency's and the lender's loan. The vendor must also agree to make annual real estate tax searches and report any delinquencies to the Centralized Service Center in St. Louis.

2. *Special Servicing*

The Agency will aggressively pursue all available special servicing remedies to help solve borrower problems. If foreclosure is necessary, each lender has an independent responsibility to protect its interest. *Form RD 1927-8, Agreement with Prior Lienholder,* requires the participating lender to notify the Agency before accelerating any loan and permits, but does not require, the Agency to pay or reinstate the prior lien to protect the Agency's interest.

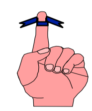
10.4 DEVELOPING STATE-BY-STATE APPROACHES TO LEVERAGING



The way in which leveraging is most effectively handled will vary state-to-state and community-to-community, depending upon market conditions, the availability of Government subsidy funds, and the interest of private lenders. For this reason, each State Director should develop an independent leveraging strategy that will encourage and facilitate the use of leveraged loans.

Elements of an Effective Lending Strategy

- Lender Outreach and Marketing
- Effective Borrower Education
- Streamlined Processing Procedures



A. Lender Outreach

Each state should implement lender outreach activities that encourage participation by all prospective lenders. For example, Field Staff should:

- Collect and maintain sales information for each market area that will enable the Loan Originator to assess whether applicants are candidates for 100 percent private financing or for leveraging.

- Identify lenders who are active in the State and provide information about the Agency's loan programs and how leveraging arrangements might work.

- Identify the sources of loan and grant funds that may be available from State and local governments, and nonprofit sources. Provide information on the Agency's loan programs to active and appropriate sources, and describe how leveraging arrangements might work.

- Consider maintaining lists of interested lenders, and information on their loan rates and terms. Care should be taken to provide information to borrowers in a manner that does not provide preferential treatment to specific lenders or borrowers.

B. Borrower Education

Each State should develop briefing materials that explain the leveraging concept and why leveraging funds may be advantageous. Some applicants may need guidance and assistance in identifying and contacting appropriate non-Agency funding sources.

C. Streamlined Processing Procedures

Lenders will be less interested in working with the Agency if the leveraging process greatly increases their processing time or their documentation requirements. Each Field Office should develop streamlined procedures for coordinating with participating lenders and for reviewing underwriting determinations made by those lenders. Each State Director should consider the following approaches:

- Develop a separate application package specifically for applicants seeking leveraged loans.

- Inform participating lenders in advance of the Agency's requirements for the qualification of appraisers, inspectors, and closing agents and, if requested, provide advance approval of lender staff or contractors who routinely provide these services for lenders’ loans.

- Provide staff training to ensure expedited review of leveraged loans.

- Develop and enter into memoranda of understanding with active lenders covering basic policies and procedures, rather than operating on a loan-by-loan basis. See Attachment 10-B for a list of topics that should be considered in developing a memorandum of understanding.
- Over time, use information from FASTeller to generate information about the performance of leveraged loans to inform lenders, and to adjust processing procedures.

SECTION 2: ORIGINATING LEVERAGED LOANS

10.5 TAKING APPLICATIONS

If the applicant applies directly to the Agency, the application procedures described in Chapter 3 should be followed. When the applicant has already completed an application to another funding source, a copy of that loan or grant application may be accepted if the other funding source used a version of the Uniform Residential Loan Application (pages 1-5 of *Form RD 410-4*). However, the applicant also must complete *Additional Information Required for RHS Assistance*, pages 6 through 8 of *Form RD 410-4, Uniform Residential Loan Application*.

10.6 REFERRING APPLICANTS TO PARTICIPATING LENDERS

Because both loan and grant funds may leverage Agency financing, any applicant for an Agency loan is a potential candidate for leveraging. Very low-income applicants will not be required to seek private financing to leverage the Agency loan, but the Loan Originator should provide information to these applicants about other sources of subsidized loans or grants.

Unless a low-income applicant's credit history is such that a private lender is unlikely to provide even a leveraged loan, the Loan Originator will use UniFi to calculate the maximum allowable loan the applicant could receive if 80 percent of the loan funds were provided by the Agency at standard rates and terms, and 20 percent of the loan funds were provided by a private lender at market rates and terms.

If the resulting maximum loan appears sufficient to enable an applicant to purchase an appropriate home in the market area, the Loan Originator must notify the applicant that a final determination of eligibility cannot be made until the applicant has attempted to obtain private financing for at least 20 percent of the loan. Applicants should be referred to lenders offering rates and terms for which the applicant appears to qualify. Attachment 10-C provides a sample explanation of the Agency's leveraging requirements that applicants or Loan Originators may use to brief participating lenders.

10.7 DETERMINING BORROWER ELIGIBILITY

> **Community Reinvestment Act (CRA)**
>
> CRA requires lenders to help meet the credit needs of the communities in which they are chartered to do business.

Applicants for Section 502 leveraged loans must meet the eligibility requirements described in Chapter 4. In addition, they may have to meet additional eligibility requirements imposed by participating lenders. Participating lender credit requirements may be more stringent than the Agency's, but the Loan Originator can encourage lenders to work with applicants who meet Agency requirements. In talking with the participating lender, the Loan Originator should stress that the Agency will be sharing risk with the participating lender and that the participating lender will hold the first lien position. Also, the lender may receive CRA credit for making loans in partnership with the Agency and leveraged loans may be sold on the secondary market.

10.8 ISSUING THE CERTIFICATE OF ELIGIBILITY

To issue *Form RD 1944-59, Certificate of Eligibility* in conjunction with a leveraged loan, the Loan Originator should follow the procedures described in Section 4 of Chapter 7, with the following exceptions. For leveraged loans, *Form RD 1944-59* will contain:

- The total maximum loan for which the applicant qualifies -- not just the Agency's portion of that loan;
- The expected Agency and lender shares of the funds to be provided; and
- A time frame of <u>60 days</u> for the applicant to identify a property -- 15 days longer than other applicants receive to allow time to work with the participating lender.

10.9 UNDERWRITING LEVERAGED LOANS

A. Lender vs. Agency Underwriting

> The Agency is responsible for making sound underwriting decisions regardless of another lender's participation.

There are many underwriting processes that may be performed by either the Agency or the lender, such as income verification, credit checks, and title clearance. Lenders should be allowed to do the primary legwork involved in collecting underwriting information. Allowing lenders to collect underwriting information does not imply that the Agency is relieved of its responsibility to make sound underwriting decisions, only that information collected by the lender is generally acceptable to use in making these decisions.

B. Property Requirements and Appraisal

The property must meet all of the requirements described in Chapter 5. The Loan Originator may accept property inspections and appraisals conducted by the participating lender, as long as evidence of the qualifications of the individuals performing these activities is provided and accepted. An administrative review of the appraisal must be completed before the appraisal is accepted. The environmental review remains the responsibility of the Agency; however, the participating lender may be requested to provide environmental information.

C. Loan-to-Value Ratio

When loans are funded solely by the Agency, the borrower's total debt may exceed the market value of the property by the total of the Agency appraisal and tax monitoring fees, plus the required contribution to establish the escrow account. Down payments are required only if the applicant's nonretirement assets exceed $7,500 ($10,000 for elderly families) or available retirement assets exceed the applicable adjusted median income. (See Paragraph 4.7.)

Some lenders may be willing to participate in a loan when the total debt exceeds the value of the property because their risk is limited by the Agency's participation in the loan. However, others will require that borrowers have some equity in the property, because they believe an investment in the property improves the likelihood that the borrowers will fulfill their commitments. This means that borrowers with leveraged loans may need to contribute more cash than other borrowers. The Loan Originator should explain to the applicant whether a cash contribution will be necessary and work with the lender to lower their usual equity requirements.

D. Loan Terms and Fees

Lenders are expected to charge reasonable and customary interest rates and fees. The Loan Originator may be able to help the applicant negotiate favorable terms.

Non-Agency loans must be amortized over a 30-year period, but may contain provisions for a balloon payment at the end of the 15th year.

E. Determining Loan Amount

The Agency loan may include costs for the initial contribution to the escrow account for taxes and insurance, even if the participating lender will manage the escrow account. The loan amount for leveraged loans is determined using the procedures described in Chapter 7, with the following exceptions.

- Payment assistance is computed using the appropriate EIR, but no floor payment.
- Agency loans leveraged with private financing should always be at the standard terms. If the loan is not affordable at standard rates and terms, the Agency's share of the loan should be increased, rather than extending the loan term or reducing the EIR.
- Use the Agency's cost for an appraisal to determine total allowable debt, even when the appraisal is performed by the participating lender's appraiser.

F. Agreements with the Participating Lender Regarding Construction

For loans that involve new construction or rehabilitation, the Agency and lender must agree on how construction inspections, payment draws, and final acceptance of the work will be handled. This may be accomplished by an agreement developed for the specific loan or through a general memorandum of understanding that covers multiple loans.

1. Inspections

Interim construction inspections completed by the participating lender may be accepted if the Field Office has approved the qualifications of the inspector. However, an Agency representative must participate in the final inspection. The participating lender may be asked to provide the Agency with a status report on implementation of any mitigation measures required by the Agency's environmental assessment; however, ultimate responsibility for compliance rests with the Agency.

2. Construction Draws

Typically, construction draws should be made by each lender in proportion to the amount of the loan each is contributing. For example, if the Agency provides 60 percent of the loan and the participating lender 40 percent, 60 and 40 percent of each draw would be paid by the Agency and the participating lender, respectively. However, there are circumstances in which another arrangement would be appropriate. For example, a participating lender might prefer to fully fund the acquisition of the site at the beginning of the construction period. If the participating lender is unwilling to provide construction funding until the Agency loan funds have been used, the Agency can provide the construction funding up to the maximum amount of the Agency's loan.

10.10 LOAN CLOSING

A joint closing generally will be held for Agency and participating lender loans. If the leveraged loan will close after the Agency loan is closed, a written, firm loan commitment from the participating lender must be provided to the Agency by the time of the Agency's loan closing. Closing procedures for the Agency's loan are identical to those described in Chapter 8. When the Agency's lien will be subordinated, the prior lien holder must execute *Form RD 1927-8, Agreement with Prior Lienholder,* unless the general conditions of such form are contained in a Memorandum of Understanding with the participating lender and such conditions apply to the lender and any assignees.

A. Required Documentation

In addition to the documentation required to support the Agency's loan, a copy of the mortgage, promissory note, evidence of title and hazard insurance, and closing documents for the non-Agency loan or grant must be provided for the borrower's case file.

B. Recording the Lien

The closing agent should be informed of the lien position the Agency will take.

ATTACHMENT 10-A

EXAMPLE: AGENCY FUNDS LEVERAGED WITH PRIVATE MARKET-RATE FINANCING

John and Phyllis Ford have been saving their money, hoping to buy a home. They have accumulated $4,000 toward a down payment and have kept their other debts low. In fact, their only ongoing debt is a $190/month car loan. John earns $20,000/year and Phyllis works in the home, taking care of their 3 children.

The couple has been house hunting on the weekends and has determined that their dream house is likely to be in the range of $70,000. Last week they approached a local lender about a loan. The lender explained that the Fords could not qualify for a loan because they could not meet the lender's down payment requirements and could not afford the monthly payments within the lender's required principal, interest, taxes, and insurance (PITI) ratio of 28 percent and total debt (TD) ratio of 36 percent at a 7.5 percent interest rate.

$70,000	Estimated Appraised Value
$70,000	Estimated Purchase Price
$ 7,000	Estimated Required Down Payment (10 percent)
$ 3,000	Estimated Loan Fees, Settlement Costs, and Initial Deposit to the Escrow
$ 110	Estimated Monthly Taxes and Insurance

To obtain a private market-rate loan, the Fords would need $10,000 in cash ($7,000 for a down payment and $3,000 for related costs that cannot be financed). They would also be required to pay $441/month in principal and interest. The resulting PITI and TD ratios would be 33 percent and 44 percent, respectively.

Based upon this information, the lender suggested that the Fords contact the Agency to obtain a Section 502 loan instead. The family qualifies for an Agency loan on the basis of income. They live in a rural area and are planning to purchase a home that is below the area loan limits for the area.

If the Fords receive a 100 percent Agency loan, no down payment is required and the appraisal and tax monitoring fees, as well as the contribution toward the escrow, can be financed.

Because the Fords are very low-income, they qualify for payment assistance at the 1 percent rate. Therefore, their monthly payment would be $215. This gives the family a PITI ratio of 20 percent and a TD ratio of 31 percent, well below the Agency's 29 and 41 percent maximums.

However, even though the Fords cannot afford 100 percent private financing, UniFi calculations indicate they could afford a leveraged loan with $20,000 provided by the lender, and the balance provided by the Agency and still meet the lender's PITI and TD ratios.

This arrangement would enable the Fords to meet the lender PITI and TD ratio requirements. The Agency's willingness to subordinate its loan to the lender's should help allay any lender concerns about loan-to-value ratio or a down payment. The Fords would not only get their dream house at a price they can afford, but also would establish a valuable relationship with a local lender. A leveraged loan would enable the Agency to assist this family using $53,000 of Agency funds, rather than $72,500.

Leverage Loan Terms

$20,000 @ 7.5% for 30 years =	$140/month
$53,000 @ 1.0% for 33 years =	$158/month
$73,000	$298/total monthly PI

$	298	Principal and interest
$	110	Taxes and insurance
$	408	PITI (Ratio = 24.4%)
$	190	Car payment
$	598	Total Debt (Ratio = 35.8%)

ATTACHMENT 10-B
SAMPLE TOPICS TO BE ADDRESSED IN A MEMORANDUM OF UNDERSTANDING

ORIGINATION

- Agency will subordinate to permit lender to obtain first lien position.
- Lender must use standard application form and obtain Agency approval of qualifications for the appraiser, inspector, and closing agent.
- Agency will be responsible for the appropriate level of environmental review; however, the lender may be asked to assist in the collection of needed environmental data.
- Agency makes independent underwriting decisions based upon reviewing the participating lender's origination package.
- Generally a joint closing will be conducted.
- For construction loans:
  - ◊ Describe how the lender will participate during the construction process (e.g., will the lender provide construction financing? will the lender defer amortization until the borrower occupies the dwelling?);
  - ◊ Describe how draws will be paid (a pro rata share from each lender is preferred);
  - ◊ Describe how inspections will be completed (e.g., if the lender completes inspections, the Agency must receive a copy of the inspection before making draw payments and an Agency inspector must make the final inspection); and
  - ◊ Describe what will happen if the Agency loan will close before the participating loan. For example, the lender must provide a firm commitment at the time of Agency loan closing, contingent only upon successful completion of the construction.

SERVICING

- Describe who will establish and maintain the escrow account. If the lender maintains the account, the lender must report annually to the Agency on the state of tax and insurance payments.
- Describe what information will be shared between lenders (e.g., results of periodic inspections, delinquency or default information). Note: Information provided by the applicant cannot be released to another party without the applicant's permission.
- Describe whether each lender will:
  - ◊ Pursue joint special servicing actions if a problem arises;
  - ◊ Notify the other in the case of default; and/or
  - ◊ Pursue a joint foreclosure action if the borrower is in default on both accounts.

ATTACHMENT 10-C
SAMPLE LEVERAGING INFORMATION FOR LENDERS

The Section 502 program provides home financing for low-income borrowers who are unable to obtain private credit. Section 502 funds can be used to purchase, build, and rehabilitate modest housing. Because the Agency's loan program is not intended to compete with available private credit, our applicants may be required to pursue private financing before being considered for an Agency loan.

Leveraging arrangements, in which the applicant receives part of needed funds from the Agency and part from a private lender, are encouraged. In order to facilitate the use of private financing, the Agency is generally willing to subordinate its loan.

Our preliminary analysis indicates that the applicant named below should be able to qualify for 100 percent private financing or a _____ leveraged loan. Your assistance in determining whether a leveraged loan is a possibility is requested. After reviewing the information provided by the applicant, please provide the information requested below. Your responses to these questions do not constitute a loan commitment or obligate your institution to approve a loan in any way. If you have any questions, please contact ____________________________. Your assistance is appreciated.

APPLICANT NAME: ____

Based on the information provided, would the applicant be considered for a loan?

☐ Yes. If so, please provide the estimated amount and terms of the loan.

$__________ Amount (If 100% private financing could not be considered, enter an estimate of the maximum loan for which the household might quality.)

$__________ Estimated cash requirement

___________ Interest rate (if applicable)

___________ Term (in years)

List any limitations on the loan purpose and make any additional comments on the back of this form.

☐ No. If not, please indicate why a loan cannot be considered.

☐ Unacceptable credit ☐ Insufficient income
☐ Other (specify below)

LENDER:____

____
Representative Name, Title, Telephone Number