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DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 570

**[Docket No. FR-5767-F-03]
RIN 2506-AC35**

**Section 108 Loan Guarantee Program:
Payment of Fees to Cover Credit Subsidy Costs**

AGENCY: Office of the Assistant Secretary for Community Planning and Development, HUD.

ACTION: Final rule.

SUMMARY: This final rule amends HUD's Section 108 Loan Guarantee Program (Section 108 Program) regulations to permit HUD to collect fees from Section 108 borrowers to offset the credit subsidy costs of Section 108 loan guarantees. The Department of Housing and Urban Development Appropriations Acts of 2014 and 2015 authorize HUD, for each of those fiscal years, to collect fees from borrowers to offset the credit subsidy costs for the guaranteed loans. This final rule amends HUD's Section 108 Program regulations to ensure that HUD can begin to make Section 108 loan guarantee commitments without appropriated credit subsidy budget authority, in accordance with applicable law. This final rule follows publication of the February 5, 2015, proposed rule and adopts the proposed rule with minor, clarifying changes to how HUD will determine and announce the amount of the fee. Elsewhere in today's Federal Register, HUD is publishing a document that sets the fee that it will charge borrowers under the Section 108 Program for loan guarantee commitments awarded in Fiscal Year (FY) 2016.

DATES: *Effective Date:* **[Insert date 30 days from date of publication in the FEDERAL REGISTER].**

FOR FURTHER INFORMATION CONTACT: Paul Webster, Director, Financial Management Division, Office of Block Grant Assistance, Office of Community Planning and

Development, Department of Housing and Urban Development, 451 7th Street, SW, Room 7180, Washington, DC 20410; telephone number 202-708-1871 (this is not a toll-free number).

Individuals with speech or hearing impairments may access this number through TTY by calling the Federal Relay Service, toll-free, at 800-877-8339. Faxed inquiries (but not comments) may be sent to Mr. Webster at 202-708-1798 (this is not a toll-free number).

SUPPLEMENTARY INFORMATION:

I. Background

A. The February 5, 2015, Proposed Rule

On February 5, 2015, HUD published a rule in the Federal Register, at 80 FR 6470, proposing to amend the Section 108 regulations at 24 CFR part 570, subpart M, to permit HUD, in accordance with statutory authority, to collect fees from Section 108 borrowers to offset the cost of Section 108 loan guarantees. HUD published its proposal in anticipation of annual appropriations that do not include budget authority for a credit subsidy and require HUD to collect fees from borrowers to cover the credit subsidy costs for guaranteeing the loans.

HUD's February 5, 2015, rule proposed establishing a new section, § 570.712, entitled "Collection of fees; procedure to determine amount of the fee," that would provide for the collection of fees for the Section 108 Loan Guarantee Program. Specifically, § 570.712 would provide that when HUD has been authorized to collect a fee for the Section 108 Program and Congress has not appropriated a subsidy for the Section 108 Program or the appropriated subsidy is insufficient to offset the costs of the Section 108 loan guarantees, HUD will collect a fee for the program. When such conditions occur, HUD stated that it would announce through notice published in the Federal Register its intent to impose a fee and explain the basis and amount of the fee imposed. The fee that would be imposed would be expressed as a percentage of the

principal amount of the guaranteed loan. Recognizing that the amount of the fee would be dependent upon the authority provided by HUD's annual appropriations to issue loan guarantee commitments and could vary from year to year, HUD proposed announcing the fee through notice published in the Federal Register rather than codifying it in § 570.712. HUD stated that the amount of the fee would reduce the credit subsidy cost to the Federal Government to a level that eliminates the need for appropriated credit subsidy budget authority.

In addition to establishing the new § 570.712, the February 5, 2015, rule proposed related amendments to other sections of part 570, subpart M, to implement the authority to charge Section 108 borrowers a fee. Specifically, HUD proposed amending § 570.701 (Definitions) to add a definition of "credit subsidy cost" to mean the estimated long-term cost to the Federal Government of a Section 108 loan guarantee or a modification thereof, calculated on a net present value basis, excluding administrative costs and any incidental effects on governmental receipts or outlays. HUD based this definition on the definition of "cost" in the Federal Credit Reform Act of 1990¹ (2 U.S.C. § 661-661f at § 661a), modified to exclude direct loans, which are not authorized under the Section 108 Program. HUD also proposed amending § 570.705(g) to add, as a loan requirement, that each public entity, or its designated public agency, and each State issuing debt obligations pay any and all fees charged by HUD for the purpose of paying the credit subsidy costs of the loan guarantee.

To facilitate the payment of these charges, HUD's February 5, 2015, rule proposed permitting the payment of these fees from guaranteed loan proceeds. HUD proposed amending § 570.703 (Eligible activities) to provide that guaranteed loan funds may be used for the payment of fees charged by HUD, when the fees are paid from the disbursement of guaranteed loan funds.

¹ The Department of Housing and Urban Development Appropriations Act, 2014, references section 502 of the Congressional Budget Act of 1974. Section 502 was added to the Congressional Budget Act of 1974 by the Federal Credit Reform Act of 1990, Public Law 101-508, title XIII, subtitle B, section 13201(a), 104 Stat. 1388-610.

In addition, to notify the public of plans to use grant funds or loan proceeds to pay the fee, HUD proposed changes to § 570.704 (Application requirements) to require that applicants include the estimated amount of the fee to be paid in the application for loan guarantee assistance. Use of grant funds for fees or payments of principal and interest would also need to be included in each applicant's consolidated plan.

Finally, HUD proposed amending § 570.200(a)(3)(iii) to clarify that when the fee is paid from the proceeds of a guaranteed loan, grant funds used to repay that loan would not be subject to the requirement that not less than 70 percent of a grantee's aggregate Community Development Block Grant (CDBG) expenditures over a specified 1-, 2-, or 3-year period be used for activities benefitting low- and moderate-income persons.² This exclusion was proposed to make clear that payment of fees would be treated as part of the cost of carrying out the activity financed with the guaranteed loan. HUD stated that Section 108 activities that benefit low- and moderate-income persons are already included in the calculation and that the activities should only be considered once when calculating overall benefit.

B. Proposed FY 2015 Fee

In addition to the February 5, 2015, proposed rule, HUD published a notice on February 5, 2015, at 80 FR 6469, proposing the amount of the fee that HUD would collect in FY 2015 to offset the credit subsidy costs to the Federal Government for making a loan guarantee. Specifically, HUD proposed a fee of 2.42 percent of the principal amount of the loan, proposed to make that fee effective in FY 2015 after available credit subsidy appropriations were depleted, and solicited public comment on the amount of the fee. HUD's February 5, 2015, notice was consistent with § 570.712(b)(2) of the proposed rule, which provided that HUD would publish a notice to establish the fee to pay the credit subsidy costs. HUD stated that it anticipated issuing

² Section 101(c) of the Housing and Community Development Act of 1974, as amended (42 U.S.C. 5301(c)).

fee notices before the beginning of the applicable fiscal year, with an effective date of the beginning of the fiscal year, and may provide updated notices as necessary. Furthermore, HUD stated that it would periodically publish the estimated subsidy cost and fee as part of the President's Budget.

C. The Department of Housing and Urban Development Appropriations Act, 2015

HUD stated in its February 5, 2015, proposed rule that the Department of Housing and Urban Development Appropriations Act, 2014³, authorizes HUD to collect fees from borrowers to offset the credit subsidy cost for the program. On December 16, 2014, the Department of Housing and Urban Development Appropriations Act, 2015⁴ (2015 HUD Appropriations Act) was enacted. The 2015 HUD Appropriations Act does not include budget authority for a credit subsidy and requires HUD to collect fees from borrowers to result in a credit subsidy cost of zero for guaranteeing loans.

Both the Senate Report (S. Rep. No. 113-182) accompanying the Senate's FY 2015 Transportation, Housing and Urban Development and Related Agencies Appropriation bill and the House Report (H.R. Rep. No. 113-464) accompanying the House's FY 2015 Transportation, Housing and Urban Development and Related Agencies Appropriation bill support the conversion of the Section 108 Program to a fee-based program. The Senate Report states that the Senate Committee on Appropriations expects HUD to move quickly to complete the rulemaking process and clearly communicate program costs and requirements to communities. The Committee concludes that it expects HUD to ensure that a financing structure is in place by the

³ Title II of Division L of the Consolidated Appropriations Act, 2014 (Public Law 113-76, 128 Stat. 5, approved January 17, 2014; 128 Stat. 604) (2014 HUD Appropriations Act).

⁴ Title II of Division K of the Consolidated and Further Continuing Appropriations Act, 2015 (Public Law 113-235, 128 Stat. 2130, approved December 16, 2014; 128 Stat. 2739) (2015 HUD Appropriations Act).

beginning of the fiscal year to ensure that this important program remains available to communities.

This final rule is consistent with the expectations expressed in the Senate Report. As discussed in this preamble, to assist with the conversion to a fee-based financing mechanism, the Section 108 Program allows Section 108 borrowers to include the fee in the guaranteed loan amount. Borrowers would also have the option to use existing statutory authority that permits the fee to be paid with CDBG funds.

II. This Final Rule

The public comment period for the February 5, 2015, proposed rule and notice closed on March 9, 2015. HUD received 10 comments on the rule and 8 comments on the notice by the close of the public comment period. Commenters included State governments, cities, trade associations, and housing development organizations, and addressed issues including the need for the fee, the amount of the fee, and the basis for the fee. The following section of this preamble summarizes the significant issues raised by the commenters on the February 5, 2015, proposed rule and notice and HUD's responses to these comments. Because similar comments were received on the rule and the notice, HUD is addressing all public comments in this final rule.

After considering the public comments received, HUD has decided to adopt the February 5, 2015, proposed rule with minor, clarifying changes. HUD is clarifying § 570.712(a) to provide that program income may be used to pay the fee. HUD is also clarifying § 570.712(b)(1) to provide that the amount of the fee shall be based on the date of the loan guarantee commitment. Finally, HUD is clarifying § 570.712(b)(2) to more accurately describe how it will announce its intent to impose the fee. Specifically, HUD is clarifying § 570.712(b)(2) to

provide, as discussed in the preamble of the February 5, 2015, proposed rule, that it would announce the fee through notice published in the Federal Register and would solicit comment on future fee notices if the assumptions underlying the fee calculation change or the fee structure itself raises new considerations for borrowers.

Given the timing of the publication of the final rule and the availability of appropriated budget authority to defray the credit subsidy cost, HUD has decided not to impose a fee with respect to FY 2015 loan guarantee commitments. After considering the public comments received, HUD is establishing the fee at 2.58 percent of the principal amount of the loan disbursements for loan guarantee commitments awarded in FY 2016. The change in the amount of the fee is based on reasons given in the notice being published elsewhere in today's Federal Register. HUD published the anticipated 2.58 percent fee for FY 2016 on February 2, 2015, as part of the FY 2016 President's Budget.⁵

III. Discussion of Public Comments on February 5, 2015, Proposed Rule and Notice

Comment: A commenter responding to the issue, "whether to require borrowers to pay fee amounts from other sources or allow borrowers to add up-front fees to the face value of the guaranteed loan by paying fees from guaranteed loan funds at the time of loan disbursement," stated that likely the best option is to build the fee into the loan proceeds amount. The commenter questioned, however, what might happen if a borrower needs to borrow a significantly large amount of money and needs to use the entire loan to subsidize the housing development or purchase. According to the commenter, the fee may deter borrowers from choosing to finance through the Section 108 Program. The commenter recommended that

⁵ The FY 2016 President's Budget for HUD is available at: <https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/hud.pdf>. The fee is specified in table 6 of the Federal Credit Supplement to the 2016 budget and is available at: https://www.whitehouse.gov/sites/default/files/omb/budget/fy2016/assets/cr_supp.pdf

borrowers be allowed to pay fees from other sources or add up-front fees to the face value of the guaranteed loan, stating that allowing borrowers the most flexibility regarding how to pay the fee would provide comfort to borrowers since the fee could result in higher net costs because the fee would take into account the risk of default and the borrower would have to pay interest on the financed fee. Another commenter stated that the fee should be imposed with as much flexibility as possible. According to the commenter, allowing the payment of the fee as part of the borrowing or with block grant funding would allow the borrower to borrow the loan fee and amortize it over the life of the loan. The commenter also stated that as entitlement communities adjust to the fee they will appreciate having the flexibility to best structure their loan deals to the project needs.

HUD Response: This final rule does not restrict borrowers to paying the fee with guaranteed loan proceeds or limit the source of the fee payment, but permits the payment with guaranteed loan funds. Specifically, as clarified by this final rule, § 570.712(a) states that “[s]uch fees are payable from grants allocated to the issuer pursuant to the Act (*including program income derived therefrom or from other sources*). . . .” (emphasis added). As a result, borrowers may use grant funds, pursuant to § 570.705(c)(1)(i), guaranteed loan funds, or program income to pay the fee.

Comment: The commenter also stated that the notice period is not explicitly stated in the proposed rule, except that it will be before the beginning of a fiscal year. According to the commenter, many borrowers plan their financial investments and obligations far in advance, and it would be good business for borrowers to be notified of the fee at least one quarter in advance of when the fee would be announced. The commenter asked whether HUD could, if unable to publish the final fee with sufficient advanced notice, publish a range of what the upcoming

year's fee might be. The commenter also stated that the annual fee might cause borrowers whose time is more flexible without the immediate need to borrow to wait and see if the fee will be lower in the upcoming year.

HUD Response: The President's Budget is typically published each February preceding the beginning of a new fiscal year. As part of the Budget, HUD is required to publish its estimated Section 108 credit subsidy costs and the fee required to offset such costs approximately 7 months before the start of the fiscal year when any new fee rate would take effect. This period provides sufficient time to notify borrowers of the fee in advance of the beginning of the fiscal year. HUD believes that this time period should also provide potential borrowers sufficient opportunity to plan their financial investments and obligations.

Comment: Several commenters stated that what the fee might be in the future is a point of concern. According to the commenters, the proposed rule states only that "future notices may provide for a combination of up front and periodic fees." As a result, how much those fees might be in the future or when they may take effect is a complete unknown. The commenters concluded that uncertainty makes any planning exercises relating to the Section 108 Program tenuous. One commenter asked HUD to reconsider the fee.

HUD Response: As stated in the response to the previous comment, HUD is required to specify the anticipated Section 108 credit subsidy cost and fee required to offset that cost approximately 7 months before the beginning of the fiscal year when the new fee rate would take effect. For fees applicable to commitments awarded in FY 2017 and thereafter, this will provide HUD sufficient time before the beginning of the fiscal year to notify potential borrowers as provided by § 570.712(b)(2). HUD would also note that only one fee schedule will apply to a loan guarantee commitment, i.e., once HUD approves the application and awards a loan

guarantee commitment, the fee applicable to the period covering the date of the commitment will apply to all loan disbursements under that commitment. HUD is clarifying this by revising § 570.712(b)(1) to state that the fee shall be based on the date of the loan guarantee commitment. HUD anticipates that applicants for Section 108 loan guarantees will have access to the fee schedule that will be applicable to commitments awarded pursuant to their applications. Thus, a Section 108 borrower that receives a loan guarantee commitment will not be subject to the kind of risk envisioned by the commenters. In response to the comment requesting that HUD reconsider the fee, without an appropriation for payment of the credit subsidy cost, HUD must impose a fee to offset credit subsidy costs of guaranteeing these loans.

Comment: A commenter stated that it would be in HUD's best interest to provide the maximum amount at which the fee may be set. According to the commenter, allowing the borrower the most flexibility with the fee will mitigate any deterrence against the newly imposed fee. Another commenter also stated that flexibility is important because no two Section 108 loans are exactly alike.

HUD Response: HUD will seek to publish a new fee rate at the earliest opportunity in order to provide borrowers maximum notice and flexibility. As noted above, HUD has seven months to notify the public of the anticipated new fee rate and will do so with sufficient time in advance of the fee taking effect. However, due to the assumptions that are taken into consideration in formulating the rate, HUD is not able to set a maximum amount at which the fee may be set.

Comment: A commenter stated that the fee is unnecessary and excessive, but recognized that the elimination of a credit subsidy appropriation requires HUD to charge some fee. Several other commenters advocated for the continuation of using appropriated credit subsidy

budget authority to address the Section 108 credit subsidy cost, but acknowledged that the President's Budget and the FY 2015 HUD Appropriation Act authorize HUD to collect fees. Several other commenters opposed any fee or other mechanism that requires grantees to pay for the subsidy cost of the program. Other commenters stated that the fee is unnecessary and counterproductive considering the fact that, as HUD pointed out in the proposed rule, "there have been no defaults in the history of the program. HUD has never had to invoke its full faith and credit guarantee, nor has it paid out on any guarantee from the credit subsidy reserved each year for future losses." According to these commenters, HUD's requirements for grantees to pledge their CDBG allocations and furnish other security interests or collateral in case of default reduce HUD's credit risk to zero. Another commenter added that as part of the Section 108 loan guarantee application process, borrowers must identify appropriate collateral to cover 100 percent of the loan amount. This commenter stated that a key role for HUD is to evaluate and approve this collateral, and that HUD has never had to invoke its 100 percent guarantee even though a number of projects have failed or gone bankrupt. Another commenter stated that because of collateralization, instituting a loan fee calculated on assumptions of default is a "functional fiction."

Another commenter stated that because HUD limits an entitlement community to borrowing up to five times its CDBG authority, a community's annual Section 108 repayment requirement would not exceed its available CDBG capacity under most common deal structures. The commenter suggested that at current rates, a standard term 20-year loan with straight amortization of the entire available loan capacity would require an annual payment of just over 25 percent of a community's CDBG allocation. According to the commenter, interest rates would have to increase to almost 20 percent to exceed a full allocation. The commenter also

stated that this calculation assumes that the community would secure any debt only with its CDBG capacity. Prudent borrowing dictates that communities provide additional security for Section 108-funded loans. The commenter (a city) stated that it subjects Section 108 loans to the most stringent underwriting and requires substantial collateral, including a mortgage position on the property, personal and corporate guaranties from the Borrower, and the establishment of project debt reserves. These protections are rigorously reviewed by HUD's staff at the local and headquarters offices and subject to extensive review by the city's staff and its external loan review committee. The commenter concluded that HUD's debt is secured both by strong underwriting and collateral at the community level, reviewed and approved by HUD staff, and ultimately guaranteed by CDBG allocations that are more than sufficient to secure against a portfolio-wide default.

Another commenter stated that the Section 108 Program is set up to ensure payment is made to the bondholders on time through a pledge of grantees' CDBG lines of credit and collateral for each loan to secure approximately 125 percent of the loan amount. Because these mechanisms are in place to safeguard the loans, the commenter questioned the reason a fee is being proposed. The commenter stated that it appears that HUD does not recognize the impact of the fee on borrowers despite permitting the credit subsidy fees to be paid with proceeds from the Section 108 Loan Guarantee Program or by using CDBG funds.

HUD Response: In order to comply with the Federal Credit Reform Act of 1990, HUD must estimate the credit subsidy cost of a loan guarantee. Under Federal credit budgeting principles, the availability of CDBG funds to repay the guaranteed loans cannot be assumed in the development of the credit subsidy cost estimate. Thus, the estimate must incorporate the risk that alternative sources are used to repay the guaranteed loan in lieu of CDBG funds, and that

those sources may be insufficient. Based on the annual rate that CDBG funds are used as repayment for loan guarantees, HUD's calculation of the credit subsidy cost must take into account the possibility of future defaults despite the history of no defaults in the program. When fees are collected by HUD, they are deposited into the *Financing Account* established in accordance with Federal Credit Reform Act procedures. The fees, together with interest earned thereon, will be used as the source for future years' default claims.

Comment: Several commenters also stated that credit subsidy is typically used to cover costs associated with delinquencies, interest subsidies, and other costs related to loans. The commenters questioned if HUD has not experienced a loss in the Section 108 Loan Guarantee Program, why charge a fee to cover those costs? One commenter stated that since there is no history of default due to the nature of the program, the fee should be as minimal as possible. Another commenter stated that HUD has not had to pay out on any guarantee from the credit subsidy reserve and asked what HUD will do with the accumulated fees it receives from grantees. Several other commenters recommended that HUD be required to keep the funds in a separate interest bearing account and, upon closeout of a grantee's Section 108 loans, that HUD should remit to the contributing grantees the fee amounts contributed plus interest minus their pro rata share of any pay-outs made from the fund by HUD. One commenter added that a portion of the fee should be available for recapture in the event that there is no default on a loan since this would be an added incentive to see that loans are underwritten properly and invested in only sustainable projects. Another commenter stated that any excess fees above actual costs should be recapitalized as credit subsidy in future years and/or credited against loan fees already paid.

HUD Response: These commenters generally question the need for the fee based on the fact that HUD has experienced no losses due to defaults on loans guaranteed under the Section 108 Program. As HUD stated in response to an earlier comment, the absence of losses to date does not mean that losses will never be incurred. The main reason that no losses have been incurred by HUD is that pledged CDBG funds have been available to repay guaranteed loans even when CDBG funds were not the planned source for repayment. If CDBG funds were not available, it is likely that some defaults would have occurred and that the collateral security for the defaulted loans would not have been sufficient to fully repay the outstanding obligations. HUD responds to the recommendation that fees be held during the loan repayment period and available for recapture by the Borrower in the event the loan is fully repaid with no default elsewhere in this discussion of public comments.

Comment: Several commenters also recommended various options for recapture of fees paid if not needed to cover actual losses (e.g., refunds or credits against loan fees already paid).

HUD Response: As stated in HUD's preceding response, collected fees are deposited into the Section 108 *Financing Account*. It is important for the public to understand that the purpose of the fee is to offset the credit subsidy cost to the Federal Government of making the loan guarantee, as of the time of the loan disbursement. The commenters understand correctly that the credit subsidy cost is an estimate and, therefore, subject to change. In fact, the Federal Credit Reform Act procedures provide for the reestimate of the credit subsidy cost annually. Although the credit subsidy cost is reestimated annually and may be reduced in subsequent years, it may also be increased. The fee is nonrefundable, even if the cost is less than initially estimated. On the other hand, the borrower is not assessed additional fees for any deficiency in amounts available to the Federal Government if the cost is greater than initially estimated. The

Federal Government assumes the risk that the fee initially charged will be insufficient to cover future losses. Thus, while borrowers do not benefit if the actual losses are less than originally estimated, they also are not penalized if losses are greater than initially estimated.

Comment: A commenter stated that HUD should consider reducing the fees based on the experience of the program because the HUD Section 108 Loan Guarantee Program is fiscally sound and that the Federal Government would not be faced with payments due to default.

HUD Response: HUD agrees that the program is fiscally sound. As stated above, however, if non-CDBG revenues are the expected source for repayment and those revenues fail to materialize as expected, it is likely that HUD would be required to make payments under its guarantee if CDBG funds are unavailable for that purpose. As also stated above, the Federal Credit Reform Act has been interpreted to preclude reliance on future, unappropriated funds in calculating the credit subsidy cost of a credit program.

Comment: A commenter stated that, in addition to publishing a notice in the Federal Register with the fee structure and levels, taking into consideration the total available commitment authority and what level of fees may be needed to operate the program, HUD should also provide statistics that explain how the fee is determined. This commenter asked whether HUD can provide an explanation for how the proposed fee of 2.42⁶ percent of the principal amount of the loan is determined and why HUD believes it should be a flat rate for the year, rather than a variable percentage based on market conditions. The commenter asked what would result if the fee is not high enough to cover the amount that would have been provided by

⁶ Commenters cited and used in examples 2.42 percent as the amount of the fee to be applied to the principal amount of loans, based on the rate specified in the proposed rule and notice. However, as noted in Section II of this final rule and as published elsewhere in today's Federal Register, HUD is establishing the fee at 2.58 percent of the principal amount of the loan for commitments awarded in FY 2016.

credit subsidies, coupled with poor market conditions, resulting in less loan obligations under the program?

HUD Response: The fee is calculated using the data on default frequency for municipal debt, the recovery rates on collateral security for comparable municipal debt, and the expected composition of the Section 108 portfolio by end users of the guaranteed loan funds. These data will be updated periodically. The fee rate is the weighted average of the data based on the expected composition of the Section 108 portfolio. The data is adjusted to reflect the availability of appropriated CDBG funds in the early years of the loan guarantee cohort. The effect of the availability of appropriated CDBG funds is to reduce the credit subsidy cost and, thus, the fee payable by borrowers. It is important to understand that the fee applicable to a Section 108 guaranteed loan will be based on the fee schedule published in the Federal Register and in effect when the loan guarantee commitment is awarded and will not be subject to change. If the rate were changed periodically, as one commenter recommended, it would introduce additional uncertainty for borrowers and would make the Section 108 Program less useful as a financing tool for community and economic development projects. HUD will specify the default and recovery rates used in connection with the two categories of municipal debt used in calculating the fee in the notice, once published.

Comment: Several commenters stated that the manner in which HUD arrived at the proposed 2.42 percent fee is confusing. The commenters stated that instead of using actual Section 108 loan data to arrive at the proposed fee, HUD looked at the default frequency for municipal debt and data on recovery rates on collateral security for comparable municipal debt, and at the expected composition of the Section 108 portfolio by end users of the guaranteed loan funds (e.g., third-party borrowers and public entities). The commenter stated that the credit

subsidy fees should be risk-based and include a number of factors surrounding a grantee's Section 108 loan performance, including the number of payments made on time and the risk level for each loan made. Another commenter stated that the fee is based on long-term data derived from general municipal debt and industrial revenue bonds (IRB) loan history. According to the commenter, IRBs have higher default rates than general purpose debt. The commenter stated that HUD based 73 percent of its calculation on the default and recovery data for IRBs and only 27 percent on general purpose debt because HUD determined that most projects funded through its Section 108 Program fit better into IRB types of activities rather than into general purpose debt. The commenter stated that this is not the case with the commenter's program and suggested that each State have its own fee structure. The commenter also stated that an argument could be made that by the nature of the security and back-up security required by HUD for Section 108 loans (plus the ultimate CDBG allocation guarantee), Section 108 is actually more similar to a general obligation type of debt than a revenue bond.

Other commenters stated that they did not understand the justification for the proposed 2.42 percent fee. According to these commenters, the notice states that the fee "would cover the cost associated with making a loan guarantee," however, the notice also states that the fee is based on assumptions on default frequency, recovery rates on collateral, the composition of the Section 108 loan portfolio by the end users, and nebulous "other factors" that HUD deems relevant. The commenters stated that there has never been a default in the history of Section 108 in which HUD has had to invoke full faith and credit or pay out any guarantee. The commenters suggested that the fee be based on costs related to the sale of notes and actual loan issuance, rather than the loan default and other costs mentioned in the notice. One commenter asked, "If

there are other costs related to the sale of notes and actual loan issuance that are no longer subsidized, why is that not the major focus of discussion?”

HUD Response: The commenters make a valid point regarding the fact that the fee represents the weighted average of data for two distinct categories of municipal debt. HUD will continue to work with the Office of Management and Budget (OMB) to study the feasibility of establishing separate fees for Section 108 loans according to which category of municipal debt is most comparable to the Section 108 loans to which a fee would apply. However, HUD has decided to retain the weighted average approach for the time being in order to avoid the disruption to the program that could be created by implementing separate fees. A Section 108 loan guarantee is not a general obligation in a large majority of cases. In some cases, however, borrowers have offered to pledge their full faith and credit.

Regarding the recommendation to focus on costs of issuance in lieu of default costs, the fee specified in HUD’s proposed rule and related notice would only be imposed to reduce the credit subsidy cost for the Section 108 Program to zero. This final rule defines *Credit subsidy cost* to mean “...the estimated long-term cost to the Federal Government of a Section 108 loan guarantee or a modification thereof, calculated on a net present value basis, excluding administrative costs and any incidental effects on governmental receipts or outlays.” Costs related to the sale of notes and loan issuances are not included in this definition and, in any event, are costs paid by borrowers and not by HUD. As stated in previous responses, the main reason why HUD has never been required to pay a default claim is that pledged CDBG funds have been available to repay the guaranteed loans. As also stated previously, the Federal Credit Reform Act has been interpreted to preclude reliance on the availability of future appropriations for purposes of calculating the Section 108 credit subsidy cost.

Comment: A commenter stated that if the fee is actually used to underwrite the staff and administrative costs of the Section 108 Program, then this should be the true nexus of the calculation for the fee being proposed.

HUD Response: As previously stated in HUD's responses to public comments, the only purpose of the fee is to reduce the credit subsidy cost to zero, and the definition of *credit subsidy cost* excludes administrative costs. As a result, the fee may not be used to pay for HUD staff or other program administration costs.

Comment: A commenter stated that the fee is based on a blended default rate of general purpose municipal debt and industrial development bonds, based on HUD's current loan portfolio. According to the commenter, the Section 108 loan is secured by future CDBG obligations, making it essentially a general debt obligation of the borrowing community. In addition, the commenter stated that unlike bonds secured by public taxation, HUD's ability to sequester CDBG allocations before distributing them to the community gives HUD complete control over the security which overall makes HUD's risk extremely low. The commenter suggested that the proposed 2.42 percent fee implies that \$1 in every \$40 lent by HUD defaults, which overestimates the default risk faced by HUD. According to the commenter, if HUD uses a blended rate, then the rate should more accurately reflect the current Section 108 default rate (zero percent).

HUD Response: Some of the factors noted by the commenter are, in effect, incorporated into the calculation of the credit subsidy cost. Using CDBG funds to make payment is not, in itself, a risk factor since borrowers are statutorily permitted to use CDBG funds to repay Section 108 loans and the loans are often most comparable to general purpose municipal debt (which has

a lower expected default rate). Compliance with program requirements is not a factor that affects payment defaults.

Comment: Several commenters stated that the proposed fee seems to be an additional fee to the “underwriting and issuance fee” currently charged to Section 108 loans assessed at the time permanent financing is obtained. These commenters stated that § 570.712, entitled “Collection of Fees; Procedure to Determine Amount of Fee,” does not address the underwriting and issuance fee currently assessed, nor the interim financing fees currently assessed by HUD’s fiscal agent. The commenters recommended that § 570.712 be revised to address all fees assessed on each Section 108 loan issuance, not just credit subsidy costs, which, according to the commenters, could be approximately 3.42 percent of the loan amount, subject to market conditions.

HUD Response: HUD does not agree with the commenters. The only purpose of § 570.712 is to authorize collection of the fee to pay the credit subsidy cost of a guaranteed loan and to establish a procedure for determining the amount of the fee. Section 570.705(g) addresses all issuance and other costs, including the new fee to pay the credit subsidy cost.

Comment: Two commenters stated that the Section 108 Program provides a relatively low cost to jurisdictions to borrow and urged HUD to keep it that way, stating that Section 108 funding is crucial to filling the gap between other committed funding and local project costs.

HUD Response: HUD agrees with the commenters and is working to ensure that the Section 108 Program continues to provide jurisdictions a source of low-cost financing.

Comment: Several commenters stated that the proposed fee of 2.42 percent of the principal amount plus the Section 108 Program’s cost of funds, currently around 4 percent, will push the net cost of borrowing Section 108 funds too high for many of the types of economic

development projects that have been undertaken, and urged HUD to lower the proposed fee. Other commenters stated that the fee will significantly reduce the value of the Section 108 Program as an economic development resource since these costs will be charged to the project, thus limiting the benefit or the financing. According to these commenters, this places an additional financial burden on borrowers and creates a disincentive to private developers and local governments to utilize this program. One commenter stated that the additional cost of the fee essentially serves as an increase in the cost of funds by 25 basis points over the term of a standard 20-year loan. According to the commenter, this is a significant cost to the financing since Section 108 debt is frequently used as gap financing, subject to a “but for” test. The increased costs of borrowing could kill projects, decrease the ability to use Section 108 financing to improve communities, and negatively impact equitable development since many projects benefit low- and moderate-income communities.

HUD Response: HUD believes that the Section 108 Program will continue to be an attractive financing source for community and economic development projects. In this regard, the rate on Section 108 loans will continue to be lower than the rate on most other taxable financing, and it will continue to offer highly flexible terms that conform to the financing needs of borrowers. While the fee will increase somewhat the cost of project financing, HUD recognizes the potential impact of the fee and will offer training to recipients to assist them in minimizing any adverse effect on their ability to meet their community and economic development needs. Based on the experience of other Federal credit programs (e.g., programs administered by the Small Business Administration) that charge fees, HUD is confident that the Section 108 Program will continue to be an effective financing tool for CDBG recipients.

Comment: Several commenters stated that there should be an exemption for borrowers with good loan portfolios (e.g., no record of late payments, defaults, adequate collateral to ensure repayment of their loans) and that have established a separate loan loss reserves to ensure repayment of their Section 108 loans. Another commenter stated that a borrower with a sound loan portfolio should be given a reprieve from these fees, unless a performance issue arises.

HUD Response: To allow for as smooth a transition as possible to the fee-based system for payment of credit subsidy costs, HUD will implement the assumptions proposed in the February 5, 2015, notice. HUD will formally announce the fee in the Federal Register once HUD has authority to award commitments and collect fees. However, HUD takes the commenters' proposal very seriously. Accordingly, the final rule will preserve the option for future revision of the fee schedule to incorporate a risk-based approach. However, it is highly unlikely that fees can be eliminated entirely because some risk of default will always exist.

Comment: One commenter sought clarification that the fee would be a one-time fee at the initiation of the loan and the final rule would not permit addition of any new fee during the term of the loan.

HUD Response: HUD is clarifying § 570.712(b)(1) to make clear that the fee will be based on the fee schedule published in the Federal Register and in effect when the loan guarantee commitment is awarded and will not be subject to change.

Comment: Several commenters stated that the fee should not apply to current Section 108 loan participants, as one commenter's program terms and assumptions have been made public based on assumptions that did not include the proposed fee, and the commenter has been advertising a rate based on current assumptions for over a year.

HUD Response: A fee will not apply to Section 108 commitments that have been approved, or to any future commitment for which appropriated credit subsidy budget authority has been obligated.

Comment: A commenter representing a State housing and community development authority stated that the primary competitive advantages of the Section 108 Program over private lenders are its scale and its rate. The commenters stated that regard to scale, the proposed fee likely will have a chilling effect on the amount individual jurisdictions are willing to borrow, particularly to capitalize lending programs such as those administered by the commenter. With regard to rate, the commenter stated that the money will become significantly less attractive to its borrowers if it must also pass the fee to its borrowers. According to the commenter, if it decides not to pass the fee to its borrowers, it would have to determine another way to cover these costs even though these costs were not considered when the benefits and costs of deploying Section 108-backed capital were originally weighted. In this era of scarce discretionary dollars, according to the commenters, this represents a considerable challenge.

HUD Response: As stated above, the payment of a fee is not required for commitments that have already been awarded. HUD anticipates that it will be authorized in FY 2016 to collect fees from borrowers to result in a credit subsidy cost of zero for guaranteeing Section 108 loans, and anticipates publishing a fee in the Federal Register pursuant to § 570.712(b)(2) of this final rule. As previously stated, the purpose of the fee is to offset the credit subsidy cost to the Federal Government of making the loan guarantee, as of the time of the loan disbursement. Fees will not be added to the interest rate.

Comment: A commenter stated that the fee would be \$968,000 on a \$40 million Section 108 loan guarantee. According to the commenter, this amount would be very difficult for a State

to pay and, if this fee were to be passed on to the end borrower, the State's interest rates would go from about 3.5 percent on permanent financing to 5.92 percent. The commenter concluded that, if HUD moves forward with the proposed fee, potential projects would look to other financial institutions, bonding entities, etc., particularly given all of the requisite Federal requirements, and the States' programs would be rendered nonviable.

HUD Response: Again, it is important to understand that the fee in FY 2016 will be an up-front payment, and will not be added to the interest rate. For example, if the interest rate on the guaranteed loan is 3.5 percent per annum, the borrower does not pay a rate of 5.92 percent per annum for both the interest and the fee. Rather, the borrower would pay the fee as a percent of the loan amount when that loan amount is disbursed by the lender to the borrower. Thereafter, the borrower would pay interest at a rate of 3.5 percent and would pay no further fees in connection with that loan disbursement. Depending on the term and principal payment schedule of the guaranteed loan, the fee will increase somewhat the borrowing costs – based on the most current Section 108 rates, the effective rate on a loan with a 20-year term would increase by approximately 25 to 30 basis points. Thus, under this example the effective borrowing cost would increase from 3.5 percent per annum to approximately 3.75 to 3.80 percent per annum. As stated in a previous response, HUD will also offer training for borrowers on how to minimize the impact of the fee.

Comment: Other commenters stated that withholding 2.42 percent of each drawdown in reserve is possible, yet is an undesirable option for States. According to the commenters, this practice would avoid the States' passing the cost down to the end borrowers, but results in States essentially paying HUD interest on money that they could never loan out and thus never receive proceeds on. One commenter stated that given the low State CDBG administrative allowance,

States would not choose their administrative allowance to pay the Section 108 fee. Another stated that the money would come from the general administrative allocation. This commenter stated that assuming that the money may take 5 years to draw down incrementally, perhaps the interest paid on an annual basis will be affordable and this is the best way to approach the added fee, but the commenter also stated that it does not know how much administrative allocation “cushion” it has. The commenter also stated that, according to a HUD field office, CDBG funds used to pay the fee will not be subject to the 70 percent low- and moderate-income benefit objective and that is helpful.

HUD Response: The commenters noted some of the issues regarding the options available to States for paying the fee. As a reminder, HUD will provide training for borrowers regarding how to minimize the adverse impact of the fee. The treatment of a state’s use of CDBG funds for payment of a fee requires clarification. The payment is authorized by § 570.705(c)(1)(i) in connection with the financing of the guaranteed loan and is not subject to the limitations on administrative costs at § 570.489.

Comment: A commenter stated that, based on its experience, the program could be operated with more efficiency so that loan decisions are rendered in a timely manner. The commenter offered to assist in developing ways to improve the process, drawing on its experience at the local level and working with different regional offices, to provide timely assistance to communities.

HUD Response: The reason for establishing the fee and the considerations in determining the rate are not affected by the timeliness of loan decisions. While HUD appreciates the offer of assistance and welcomes suggestions to improve the general process of administering

the Section 108 Program, including providing assistance to local communities, such operations would not impact the necessity or amount of the fee.

IV. Findings and Certifications

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) (5 U.S.C. 601 et seq.), generally requires an agency to conduct a regulatory flexibility analysis of any rule subject to notice and comment rulemaking requirements unless the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities.

This rule implements HUD's statutory authority to collect fees from borrowers to cover the credit subsidy costs of loan guarantees. As discussed in this preamble, HUD assists Section 108 borrowers' transition to a fee-based financing mechanism by allowing borrowers to include the fee in the guaranteed loan amount. This rule also permits borrowers to pay the fee with pledged CDBG funds. The amount of the fee would be determined by the amount required to fully offset the credit subsidy cost of the loan guarantees.

The 2015 HUD Appropriations Act does not appropriate credit subsidy budget authority for the Section 108 Program but requires that HUD charge borrowers a fee to result in a credit subsidy cost of zero. As a result, this rule reflects statutorily authorized actions which HUD determined that it must take to ensure uninterrupted operation of the Section 108 Loan Guarantee Program. By allowing borrowers to include the fee in the guaranteed loan amount or pay the fee with grant funds, guaranteed loan funds, or program income, HUD has strived to minimize the impact that imposing a fee may otherwise have on the program. Accordingly, it is HUD's determination that this rule does not have a significant economic impact on a substantial number of small entities.

Environmental Review

In accordance with 24 CFR 50.19(c)(6), this rule involves establishment of a rate or cost determination and related external administrative requirements and procedures which do not constitute a development decision that affects the physical condition of specific project areas or building sites. Accordingly, under 24 CFR 50.19(c)(6), this rule is categorically excluded from environmental review under the National Environmental Policy Act of 1969 (42 U.S.C. 4321).

Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial direct compliance costs on State and local governments and is not required by statute or the rule preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This rule does not have federalism implications and does not impose substantial direct compliance costs on State and local governments nor preempt State law within the meaning of the Executive order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531-1538) (UMRA) establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments and on the private sector. This rule does not impose any Federal mandates on any State, local, or tribal governments, or on the private sector, within the meaning of UMRA.

Catalog of Federal Domestic Assistance

The Catalog of Federal Domestic Assistance (CFDA) program number for the Section 108 Loan Guarantee program is 14.248.

List of Subjects in 24 CFR Part 570

Administrative practice and procedure, American Samoa, Community Development Block Grants, Grant programs-education, Grant programs-housing and community development, Guam, Indians, Loan programs-housing and community development, Low and moderate income housing, Northern Mariana Islands, Pacific Islands Trust Territory, Puerto Rico, Reporting and recordkeeping requirements, Student aid, Virgin Islands.

Accordingly, for the reasons described in the preamble, HUD amends 24 CFR part 570 as follows:

PART 570-- COMMUNITY DEVELOPMENT BLOCK GRANTS

1. The authority citation for 24 CFR part 570 continues to read as follows:

Authority: 42 U.S.C. 3535(d) and 5301-5320.

2. In § 570.200, revise paragraph (a)(3)(iii) to read as follows:

§ 570.200 General policies.

* * * * *

(a) * * *

(3) * * *

(iii) Funds expended for the repayment of loans guaranteed under the provisions of subpart M of this part (including repayment of the portion of a loan used to pay any issuance, servicing, underwriting, or other costs as may be incurred under § 570.705(g)) shall also be excluded;

* * * * *

3. In § 570.701, add in alphabetical order the definition of “Credit subsidy cost” to read as follows:

§ 570.701 Definitions.

* * * * *

Credit subsidy cost means the estimated long-term cost to the Federal Government of a Section 108 loan guarantee or a modification thereof, calculated on a net present value basis, excluding administrative costs and any incidental effects on governmental receipts or outlays.

* * * * *

4. In § 570.703, add paragraph (n) to read as follows:

§ 570.703 Eligible activities.

* * * * *

(n) Payment of fees charged by HUD pursuant to § 570.712.

5. Amend § 570.704 by adding paragraph (a)(1)(i)(D), revising paragraph (a)(1)(v), and removing and reserving paragraph (c)(2) to read as follows:

§ 570.704 Application requirements.

(a) * * *

(1) * * *

(i) * * *

(D) A description of any CDBG funds, including guaranteed loan funds and grant funds, that will be used to pay fees required under § 570.705(g). The description must include an estimate of the amount of CDBG funds that will be used for this purpose. If the applicant will

use grant funds to pay required fees, it must include this planned use of grant funds in its consolidated plan.

* * * * *

(v) If an application for loan guarantee assistance is to be submitted by an entitlement or nonentitlement public entity simultaneously with the public entity's submission for its grant, the public entity shall include and identify in its proposed and final consolidated plan the activities to be undertaken with the guaranteed loan funds, the national objective to be met by each of these activities, the amount of any program income expected to be received during the program year, and the amount of guaranteed loan funds to be used. The public entity shall also include in the consolidated plan a description of the pledge of grants, as required under § 570.705(b)(2), and the use of grant funds to pay for any fees required under § 570.705(g). In such cases the proposed and final application requirements of paragraphs (a)(1)(i), (iii), and (iv) of this section will be deemed to have been met.

(c) * * *

(2) [Reserved]

* * * * *

6. Amend § 570.705 by revising the heading of paragraph (c) and revising paragraph (g) to read as follows:

§ 570.705 Loan requirements.

* * * * *

(c) Use of grants for loan repayment, issuance, underwriting, servicing, and other costs.

* * * * *

(g) Issuance, underwriting, servicing, and other costs. (1) Each public entity or its designated public agency and each State issuing debt obligations under this subpart must pay the issuance, underwriting, servicing, trust administration, and other costs associated with the private sector financing of the debt obligations.

(2) Each public entity or its designated public agency and each State issuing debt obligations under this subpart must pay any and all fees charged by HUD pursuant to § 570.712.

* * * * *

7. Add § 570.712 to subpart M to read as follows:

§ 570.712 Collection of fees; procedure to determine amount of the fee.

This section contains additional procedures for guarantees of debt obligations under section 108 when HUD is required or authorized to collect fees to pay the credit subsidy costs of the loan guarantee program.

(a) Collection of fees. HUD may collect fees from borrowers for the purpose of paying the credit subsidy cost of the loan guarantee. Each public entity or its designated public agency and each State issuing debt obligations under this subpart is responsible for the payment of any and all fees charged pursuant to this section. The fees are payable from the grant allocated to the issuer pursuant to the Act (including program income derived therefrom) or from other sources, but are only payable from guaranteed loan funds if the fee is deducted from the disbursement of guaranteed loan funds.

(b) Amount and determination of fee. (1) HUD shall calculate the amount of the fee as a percentage of the principal amount of the guaranteed loan as provided by this section, based on a determination that the fees when collected will reduce the credit subsidy cost to the amount established by applicable appropriation acts. The amount of the fee payable by the public entity

or State shall be based on the date of the loan guarantee commitment and shall be determined by applying the percentages announced by Federal Register notice to guaranteed loan disbursements as they occur or periodically to outstanding principal balances, or both.

(2) HUD shall publish in the Federal Register the fees required under paragraph (a) of this section, announcing the fee to be applied, the effective date of the fee, and any other necessary information regarding payment of the fee and, if necessary, provide a 30-day public comment period for the purpose of inviting comment on the proposed fee before adopting changes to the assumptions underlying the fee calculation or if the fee structure itself raises new considerations for Borrowers. HUD will publish a second Federal Register notice, if necessary, after consideration of public comments.

Date: October 26, 2015

Harriet Tregoning, Principal Deputy Assistant
Secretary for Community Planning and
Development

Nani A. Coloretti, Deputy Secretary

Approved: October 19, 2015

[FR-5767-F-03]