

**DEPARTMENT OF HOUSING AND
URBAN DEVELOPMENT**

24 CFR Part 570

[Docket No. FR-4067-P-01]

RIN 2506-AB82

**Community Development Block Grant
Program for States; Revisions to
Program Income Requirements and
Miscellaneous Amendments; Notice of
Proposed Information Collection
Requirements**

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

ACTION: Proposed rule.

SUMMARY: This rule contains proposed changes to several sections of the regulations for the Community Development Block Grant (CDBG) Program for States. This proposed rule would streamline and update the regulations with regard to recent statutory changes, clarify the program income requirements, and correct other identified deficiencies in the State CDBG regulations. This proposed rule would also provide States additional flexibility in their administration of the program.

DATES: Comments due date: May 12, 1997.

ADDRESSES: HUD invites interested persons to submit comments regarding this proposed rule to the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410. Communications should refer to the above docket number and title. Facsimile (FAX) comments are not acceptable. A copy of each communication submitted will be available for public inspection and copying between 7:30 a.m. and 5:30 p.m. weekdays at the above address.

HUD also invites interested persons to submit comments on the proposed information collection requirements in this proposed rule. Comments must refer to the above docket number and title, and must be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Attention: Desk Officer for HUD, Washington, DC 20503.

FOR FURTHER INFORMATION CONTACT: Steve Johnson, Assistant Director, State & Small Cities Division, Room 7184, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410; telephone number (202) 708-1322 (this number is

not toll-free). Hearing- or speech-impaired persons may access the number via TTY by calling the Federal Information Relay Service at (800) 877-8339. FAX inquiries (but not comments on the rule) may be sent to Mr. Johnson at (202) 708-2575 (this number is not toll-free).

SUPPLEMENTARY INFORMATION

Background

This proposed rule would revise the regulations for the State Community Development Block Grant Program (24 CFR part 570) to respond to problems HUD has identified in the program, to implement a 1992 statutory change to the Housing and Community Development Act of 1974 (the Act) (42 U.S.C. 5301-5320), to implement changes resulting from the Cash Management Improvement Act, and to provide additional flexibility to States in implementing their programs. Specifically, this rule contains: (1) Proposed changes to the requirements governing Federal grant payments to States; (2) Various proposed changes to the program income requirements, including the situations in which income earned on grant funds must be remitted to the U.S. Treasury; (3) A proposed change regarding revolving funds; (4) The proposed application of the Entitlement regulations governing lump-sum drawdowns to the State program; (5) The proposed application of the Entitlement regulations governing the use of escrow accounts for rehabilitation of residential properties to the State program; (6) A proposed change to the conflict of interest requirements; (7) A proposed change regarding use of CDBG funds outside the jurisdiction of the recipient; and (8) A proposed change to the general provisions regarding a State's administrative flexibility. Each of these proposed changes is described below.

Federal Grant Payments

Section 570.489(c) of the State CDBG regulations describes the requirements concerning Federal grant payments to States. Pursuant to the Treasury Department's regulations in 31 CFR part 205, States and units of general local government must minimize the elapsed time between receipt of Federal funds and their disbursement for grant activities. This regulation was based on the provisions of the Intergovernmental Cooperation Act (31 U.S.C. 6503).

The Intergovernmental Cooperation Act has been superseded by the Cash Management Improvement Act of 1990, as amended in 1992 (31 U.S.C. 3335, 6503), which made several fundamental

changes to the manner of Federal-State payments. The Treasury Department amended the implementing regulations in 31 CFR part 205 on December 21, 1992 (57 FR 60676). Under the new regulations, States and the Treasury Department enter into agreements covering all Federal programs over a certain threshold funding level.

Through these agreements, States select specific payment techniques that are designed to prevent delays between drawdown and disbursement of funds. For programs that are below the threshold, States must use alternative procedures to prevent delays between drawdown and disbursement of funds. In 1995, only two States' CDBG allocations fell below the threshold.

Section § 570.489(c)(2) of the State CDBG regulations provides that interest earned by units of local government on funds held pending disbursement is not program income, and they must generally return such interest to the U.S. Treasury. The paragraph further provides, however, that States generally do not have to return interest earned during the time between receipt of funds and disbursement to local governments.

The December 21, 1992 amendments to 31 CFR part 205 render some of § 570.489(c) obsolete. Therefore, rather than repeat the requirements for States in the State CDBG regulations, § 570.489(c) of this proposed rule would simply refer to the more detailed requirements in 31 CFR part 205. However, this proposed rule would retain the existing requirement that States ensure that units of local government also minimize the time between receipt of CDBG funds and their disbursement, by moving the provision to the program income requirement section (§ 570.489(e)). This proposed move is further discussed in the Program Income Requirements section of this preamble, below.

Program Income Requirements

The proposed changes to the program income provisions that are described in this section of the preamble respond to the amendments of the Housing and Community Development Act of 1992 (the 1992 Act) (Pub. L. 102-550, approved October 28, 1992; 106 Stat. 3672), HUD Inspector General recommendations, and an opinion issued by the Comptroller General of the United States.

Implementation of 1992 Statutory Amendments

The State CDBG regulations currently provide for several situations in which program income received by a unit of

general local government after closeout of its grant from the State would not be subject to the program income requirements in § 570.489(e). However, the 1992 Act amended section 104(j) of the Housing and Community Development Act of 1974 (42 U.S.C. 5304(j)) to provide that the use of program income must be governed by all normal CDBG program requirements for as long as the program income exists. (Another statutory change, along with several regulatory initiatives, was reflected in the CDBG Program Economic Development Guidelines final rule, published on January 5, 1995 (60 FR 1922)). At that time, HUD noted that further regulatory changes were forthcoming to implement fully the 1992 amendments to the Act. With this amendment in the 1992 Act regarding post-closeout program income, Congress intended to expand the coverage of program requirements to all repayments that are classified as program income. This amendment applies to all program income generated by grants made by States from funds in Fiscal Year (FY) 1993 and later.

A major problem that States face in implementing the statutory amendment is that a community may continue to generate and use program income long after the initially-funded activity is completed. States generally close out grants to local governments upon completion of the initially-funded activities, though closeouts may be conditioned upon the satisfactory completion of certain other actions, such as submission of an audit or fulfillment of job creation requirements. This new statutory provision significantly extends States' responsibilities in tracking program income. To provide as much flexibility as possible within the constraints of the law, HUD proposes to allow States to demonstrate compliance with this requirement in the following ways:

(1) States may maintain contractual relationships with units of general local government for as long as there is program income to be tracked. Since, in some cases, receipt of program income by a local government may be sporadic, a State could craft its contractual agreements so that they terminate once a local government has exhausted its program income, and re-activate upon receipt of new program income at some future date.

(2) States may require local governments to obtain advance State approval of a local plan to expend program income, in the absence of a more formal contractual relationship. This arrangement may be well-suited for States that presently use a "conditional

closeout" process, in which a grant recipient has program income on hand at the time of grant closeout or receives program income after closeout of the grant that generated the program income.

(3) States may seek HUD approval of an alternative method for demonstrating compliance. HUD intends that field offices, not Headquarters, would grant such approval.

States may select different approaches for different types of grant recipients. For example, a State that distributes some of its funds on a formula basis and some on a competitive basis might select option number 1, above, for those units of local government that receive funding every year, and option number 2 for other grant recipients. A State might also blend the first two options by requiring a plan for the use of program income by local governments as part of its contractual agreement with units of general local government.

Program income is a significant resource in the State CDBG program, and it constitutes a major multiplier of the benefits that the CDBG program provides to citizens and beneficiaries. For example, during Fiscal Years 1992-1994, the cumulative amount of program income received by all States averaged over \$43.2 million per year; that is more than double the average yearly allocation amount to States during that period (\$20.2 million). This represents only that portion of program income that was returned to the States by units of general local government. HUD has not previously required States to report on program income retained at the local level. However, consistent with the 1992 amendments, HUD now proposes in § 570.489(e)(4) to require States' annual performance reports to include the use of program income held by local governments.

HUD recognizes that implementation of this statutory change may significantly affect the reuse of a large dollar volume of income retained by local governments. Because States have not previously reported to HUD on locally-retained income (whether classified as program income or as miscellaneous revenue), HUD cannot accurately predict the financial implications of this proposed rule change. HUD welcomes comments on the amount of income that will now be subject to program income requirements, and on resulting effects on what such funds are used for.

Continuing Applicability of Previous Regulations

In the last few years, there have been a succession of regulatory changes to the

State CDBG program income requirements. Presently, States must administer multiple sets of requirements, each of which applies to program income received during different time periods. Program income received prior to December 9, 1992 was subject to the requirements laid out in various policy memoranda issued subsequent to the issuance of amended State CDBG regulations on April 8, 1982 (47 FR 15297). HUD formalized those policies in a final rule published in the Federal Register on November 9, 1992 (57 FR 53397). Program income generated from grants made by States with Fiscal Year 1993 and later funds is subject to the 1992 statutory amendments as well as the requirements of the November 9, 1992 final rule. Finally, the January 5, 1995 CDBG Program Economic Development Guidelines final rule (60 FR 1922) included an expanded list of revenues that are not considered program income.

States have reported that tracking different requirements as they apply to different funding years is complicated and time-consuming, especially for program income retained at the local level. Repayments of loans made from one grant to a given community may be subject to different requirements than repayments of loans made from a subsequent year's grant to the same community. This results in an increased record-keeping burden on both the State and local governments. The complexity and burden are compounded when program income is used to make additional loans, which, in turn, generate more program income. It is not clear to some States whether program income is subject to the requirements in effect at the time the State awarded the initial grant to the locality, or to the requirements in effect when the program income is received.

To address this confusion, HUD is proposing to clarify the continuing applicability of previous program income requirements to program income retained by localities. (The problem does not occur with program income returned to States for redistribution. Since State-held program income is redistributed according to the method of distribution in effect at the time that it is redistributed, such program income is treated the same as a State's regular allocation of funds for that year; this includes being subject to the same other CDBG program requirements.) This proposed rule would provide that program income that results from an activity funded from FY 1992 and earlier funds remains subject to the requirements as they currently exist. The new provision in this proposed rule

would apply to FY 1993 and later funds. If a local government commingles program income from pre-1993 grants with program income from a newer grant, the new provision in this proposed rule would apply to all the program income, as the local government would not be able to distinguish which income came from which grant.

Some States have reported that reducing the number of different program income requirements would also simplify compliance with the requirements. In response to these suggestions, this proposed rule would provide an alternative to the "continuing applicability" provision described in the previous paragraph. States would have the option of applying these new provisions to all program income held by units of local government, regardless of the source year of the funding that generated the program income. Subjecting all outstanding locally-held program income to these proposed requirements would greatly simplify the tracking of program income and would reduce confusion over which set of requirements applies to which program income dollars. However, the proposed requirements would be more restrictive. Application of the new requirements to pre-FY 1993 funding could mean that some funds would be reclassified as program income rather than miscellaneous revenue, which could reduce local governments' flexibility in expending such funds. Furthermore, applying the new rules to previously-generated program income would probably require amending the existing grant contracts with units of local government, which would reduce any staff time savings resulting from simplified tracking of program income.

However, the potential administrative benefits to States and local governments may outweigh the negative impact of reduced local flexibility in enough cases to justify this option. HUD particularly welcomes comments on the practical implications of this option, on the net savings of staff time resulting from the option, and the effects on State grant recipients.

Miscellaneous Improvements and Updates

States have requested several clarifications of the program income requirements, and HUD has discovered other areas that call for regulatory redress. In substantially updating the program income requirements contained in § 570.489(e), HUD is proposing to incorporate the following changes.

(1) Selling off loan portfolios in order to expedite the receipt of program income. In order to maximize available financial resources, communities are increasingly selling portfolios of loans on the secondary market, or selling obligations secured by loan portfolios. Several communities have recently requested HUD's approval to "net out" of the proceeds from such sales the various legal and other costs that are incurred when a grantee sells or securitizes a portfolio. There are similarities between such situations and the currently-allowed provision whereby costs incidental to the generation of program income from the rental or use of CDBG-assisted real or personal property may be netted out of the gross income received. Therefore, this proposed rule would amend § 570.489(e)(1) (vi) and (vii) to allow legal and other costs associated with the sale or securitization of CDBG-funded loans to be netted out before the amount of program income is determined. This provision, however, would be limited to costs that are not already eligible as general administrative costs of either the State or the unit of general local government.

(2) \$25,000 per year exception. Section 104(j) of the Act allows the Secretary to exempt from the program income requirements amounts that are so small that the tracking thereof would pose an administrative burden. In the CDBG Program Economic Development Guidelines final rule (January 5, 1995; 60 FR 1922), HUD raised this threshold in § 570.489(e)(2) from \$10,000 to \$25,000 per year per unit of general local government. Some confusion apparently exists over how to apply this threshold. This proposed rule would revise the wording of this paragraph slightly to clarify that this threshold applies only to program income retained by a unit of general local government and its subrecipients; the threshold applies separately to each unit of local government. As with the currently-existing rule, this provision would not apply to program income that a unit of local government earns but returns to the State.

(3) Remission of grant funds. This proposed rule would add § 570.489(e)(2)(v), listing certain types of interest earnings that are not considered to be program income. Two of these provisions would respond to HUD Inspector General findings and implement an opinion of the Comptroller General of the United States that income generated by an ineligible CDBG-assisted activity must be returned to the U.S. Treasury. Since, in the context of the Comptroller

General opinion, eligibility includes meeting a national objective, this provision should invoke a sharpened grantee focus on successful outcomes; interest generated from CDBG-funded loans could only be kept by the grantee when the assisted activities meet the national objective requirements.

The third provision (at § 570.489(e)(2)(v)(C)) requiring that most interest earned by units of general local government on grant advances (prior to disbursement of the funds for activities) be returned to the U.S. Treasury, already appears in the State CDBG regulations at § 570.489(c)(2). Concordant with the proposed revision of § 570.489(c) (described above), this proposed rule would move the requirement to § 570.489(e)(2)(v) to complete the listing of what is not program income. This proposed rule would simultaneously update this provision to note that interest earned on escrow accounts, unlike interest earned on lump sum drawdowns, must be returned to the Treasury.

HUD issued comparable provisions in a final rule for the Entitlement CDBG program, published on November 9, 1995 (60 FR 56893). In responding to public comments in that rulemaking, HUD provided guidance on the extent and applicability of these provisions. Readers with a particular interest in these provisions may wish to read the preamble to the November 9, 1995 final rule (60 FR 56892).

(4) Program income generated by loans to subrecipients. This proposed rule would clarify, in § 570.489(e)(2)(iv), that units of general local government may receive program income from subrecipients, while eliminating any double-counting of program income received through that process. This proposed rule would classify such repayments as "transfer[s] of program income." If the funds used by a subrecipient to make principal or interest payments on a CDBG loan it received from a unit of general local government consist solely of program income received by the subrecipient, no amount of those payments to the grantee represents "new income" to the grantee's CDBG program as a whole. If, however, the subrecipient uses non-CDBG funds to make the principal or interest payments, those payments to the local government are "new income" to the CDBG program; this proposed rule would not affect the treatment of such payments. HUD added a similar provision to the Entitlement program regulations in the November 9, 1995 final rule (60 FR 56893).

(5) Program income retained at the local level. Section 104(j) of the Act

allows a State to require that a unit of general local government pay the State any income to be used by the State to fund additional eligible community development activities, except that the State must waive this requirement to the extent that such income is applied to "continue the activity from which such income is derived."

HUD gives States the flexibility to define the phrase "continue the activity from which such income is derived." HUD is aware of situations in which States found that a unit of local government failed to use program income in accordance with other program requirements, or was not making any efforts to expend its program income to continue the activity. HUD does not believe that Congress intended the above provision to override other programmatic requirements to the extent that a community must be allowed to retain the program income in egregious cases. This proposed rule, in § 570.489(e)(3)(ii)(A), would clarify that a State's definition of what constitutes "continuing the activity from which such income is derived" can include consideration of whether the program income is not being used (or is unlikely to be used) to continue the activity in a timely manner or in accordance with other program requirements.

In some situations, a State may determine that a unit of local government will use program income to continue the activity from which the income is derived, but that the amount of program income on hand exceeds projected cash needs for the near future. For example, community Y has a demand for about two housing rehabilitation loans per month, but has enough program income on hand to fund 10 average-sized loans. A State could require the unit of local government to return some or all the program income to the State's CDBG program income account until such time as it is needed by the local government. The State could disburse these funds to other units of general local government in the meantime rather than drawing funds from its line of credit.

When the local government needs its program income, the State could disburse the funds from the program account, or as necessary draw an equivalent amount from the State's line of credit for disbursement to the local government. This would increase the effective "buying power" of a State's CDBG funds, because the funds would be expended sooner. The reduced interest losses to the U.S. Treasury would be a potential side benefit, as States would need to draw funds from

their line of credit somewhat less frequently. States would have the flexibility to define the time period over which cash needs for program income would be projected, and the appropriate level of program income that could be retained in the local government's own program account.

(6) State administrative costs. States may include program income in the base of funds against which they may deduct \$100,000 plus up to 2 percent for State administrative costs. This is easily done for program income that is returned to the State, as those funds are already in the State's hands. States may find it more difficult to claim a portion of locally-held program income within their administrative costs allowance. Therefore, this proposed rule would provide, in § 570.489(e)(3)(ii), that a State could require a unit of general local government to return, for the State's use, up to 2 percent of program income retained at the local level.

Revolving Loan Funds

Revolving funds are typically established and administered in the following manner. A loan is made with CDBG funds (e.g., to a business to expand). Payments on that loan (i.e., principal, interest, or both) constitute program income that is credited as CDBG program income on the local government's books and held in an account independent of other program accounts. The program income in that account, including interest earned on the funds while on deposit pending their reuse, becomes the source of financing for additional loans of the same type. Hence, the term "revolving fund" has been used to describe such a fund. Revolving funds are used most frequently in connection with housing rehabilitation and economic development projects that involve loans.

A number of States have found regional revolving loan funds to be an efficient means of collecting and redistributing program income held at the local level. Such loan funds are often operated by a non- or quasi-governmental organization that administers programs as a subrecipient of the local government(s) to which HUD awarded grants. (Since these regional entities are usually not units of general local government, they may not directly receive CDBG funding.) Any program income they administer still belongs to the unit(s) of general local government whose grant(s) generated the program income. Successive reuses of program income must continue to be traceable back to individual localities' grants. This presents a problem if a regional loan fund is administering

program income generated by multiple communities' grants.

Regional loan fund operators may wish to use program income to fund activities anywhere in their service area, regardless of which community the program income belongs to. However, while units of general local government may use CDBG funds for activities outside their jurisdictional boundaries, each such community must determine that it is meeting its community development needs by doing so. It may be difficult for community A to reasonably conclude that its citizens benefit by having its program income used for an activity in community B, 60 miles away.

Despite these problems, HUD supports efforts to establish regional loan funds. Economies of scale can often be achieved in the administration of such programs. Regional economic development efforts may be more cognizant of the regional nature of rural economies, and better positioned to act accordingly. Assessing the benefits of individual economic development projects may also make sense from a regional perspective, as employees of businesses in rural communities frequently commute from residences in other communities.

To provide flexibility, the present State CDBG regulations in § 570.489(f)(2) offer three options regarding revolving loan funds. First, States may make awards to combinations of governments. Under such an arrangement, program income can be reused within the jurisdiction of any of the participating local governments. Second, if both the activities and the regional entity that carries out the activities qualify under section 105(a)(15) of the Act, repayments generated from these activities are not within the definition of "program income," and so are not subject to program requirements. Third, a State may itself operate a statewide revolving fund to redistribute to units of general local government program income returned to the State.

This proposed rule, in § 570.489(f)(2), would expand upon this third option by allowing a State to operate one or more revolving funds on a regional or statewide basis. Providing that the State determines that the program income will not be used to continue the same activity, a State can presently require program income generated from grant-funded activities to be returned to the State. With the proposed change, a State could, in essence, designate a regional revolving loan fund as a "State" revolving fund. A State could, pursuant to this proposal, require such program

income to be repaid to a State-designated regional revolving fund. The State could then contract with a regional entity to administer the fund (including the distribution of program income to local governments) on behalf of the State. Because the program income belongs to the State, the regional entity could, under the auspices of the State and its method of distribution, distribute it to any other eligible unit of local government covered by the regional revolving fund. The community whose initial grant generated the program income would have no further responsibility for the reuse of the program income. Subsequent repayments of program income would belong to the State, rather than belonging to a unit of local government, and the regional fund entity could award the funds, on behalf of the State, to units of general local government anywhere within the region. Any State choosing this approach would, of course, need to describe its process in the method of distribution contained in its consolidated plan.

Lump Sum Drawdowns

Section 104(h) of the Act allows units of local government to make lump sum drawdowns of CDBG funds to establish revolving loan funds for property rehabilitation activities. Paragraph (2) of that section requires HUD to establish standards governing lump sum drawdowns. Such standards exist in the CDBG Entitlement program regulations in § 570.513; however, HUD has never created comparable regulations for the State CDBG program. This proposed rule would amend § 570.513 so that its requirements could apply both to the Entitlement CDBG program and the State CDBG program; certain adaptations would be necessary to recognize the States' review and determination responsibilities, which HUD itself fulfills in the Entitlement program. With this proposed rule, HUD does not intend to make any substantive changes to the requirements of § 570.513 as they apply in the Entitlement program.

HUD reminds States that use of lump sum drawdowns is limited to the rehabilitation of privately-owned properties. This can include residential, commercial, and industrial properties; however, this would not include other forms of economic development assistance. Interest earned on lump sum drawdowns is classified as program income, and so is not subject to the return-of-interest provision in the existing § 570.489(c)(2) and the proposed § 570.489(e)(2)(v).

Use of Escrow Accounts for Rehabilitation

Similarly, § 570.511 allows Entitlement communities to establish escrow accounts for funding loans and grants for the rehabilitation of privately-owned residential property. Again, HUD has never created comparable regulations for the State CDBG Program. This proposed rule would amend § 570.511 so that its requirements could apply both to the Entitlement CDBG program and the State CDBG program, including appropriate adaptations respecting the role of States. With this proposed rule, HUD does not intend to make any substantive changes to the requirements of § 570.511 as they apply in the Entitlement program.

Paragraph (c) of § 570.511 of the Entitlement regulations concerns remedies for noncompliance. That paragraph gives HUD the authority to require a recipient to discontinue the use of escrow accounts. As adapted to apply to the State CDBG program in this proposed rule, the paragraph would indicate that States have authority under § 570.492(b) to discontinue a local government's use of escrow accounts if a State determines that a unit of general local government has failed to use an escrow account in accordance with § 570.511.

The escrow accounts provision is more limited in applicability than the lump sum drawdown provision; escrow accounts may be utilized only for the rehabilitation of primarily residential privately-owned properties. Furthermore, interest earned on grant funds placed in escrow accounts is not program income; it must be returned to the U.S. Treasury.

Conflict of Interest Provisions

HUD recently amended the conflict of interest provisions in the Entitlement program regulations (§ 570.611) in a final rule published on November 9, 1995 (60 FR 56893). The amendments to § 570.611 in the November 9, 1995 final rule were in response to public comments HUD received on the conflict of interest requirements during the course of the rulemaking.

The State CDBG conflict of interest provisions in § 570.489(h) date from a November 9, 1992 final rule (57 FR 53397). In today's proposed rule, HUD would make minor changes to these provisions to make them consistent with § 570.611 of the CDBG Entitlement regulations.

The introductory discussion of § 570.489(h)(2) describes the general principle concerning conflicts of interest as applicable "[e]xcept for

eligible administrative or personnel costs." HUD deleted this introduction from the Entitlement program regulations in the November 9, 1995 final rule, based on public comments that expressed confusion over the phrase. Several commenters described potentially troublesome situations that could arise from the inclusion of the phrase. HUD is not aware of any problems that have arisen in the State CDBG program as a result of the present wording. However, to promote consistency of regulatory approach between the two programs, this proposed rule would delete the reference to administrative or personnel costs from the regulations for the State program. HUD specifically requests comments from interested parties on what effect (if any) this deletion would have on the program. Commenters may wish to read the preamble to the November 9, 1995 final rule for further discussion of this issue (60 FR 56901).

This proposed rule would make several other wording changes in § 570.489(h)(2) concerning prohibited conflicts of interest. These changes would eliminate a redundant phrase, eliminate confusion over what sort of benefit a person might receive in a contract that would be nonfinancial in nature, and clarify that family ties of greatest concern are those with immediate family members.

Spending Funds Outside the Jurisdiction of the Recipient

This portion of the proposed rule would revise § 570.486(b). Under the existing regulations, CDBG-funded activities may serve beneficiaries living outside the jurisdiction of the unit of general local government if the unit of government determines that the activity is meeting its needs under the Act. Two emerging trends suggest that further regulation in this area is appropriate. In both situations, citizens may not be aware that funds that were supposed to benefit one community are being spent to benefit another.

First, States and units of general local government are increasingly using regional organizations to administer revolving loan funds on behalf of local governments. These regional entities, which may administer grants from multiple localities, often seek the flexibility to use program income generated from these grants anywhere within their service area, regardless of which community's grant generated the program income. This presents a problem. Local governments cannot completely abdicate to regional entities their responsibility to ensure that program income generated from their

grant is used to meet the community's needs.

Second, HUD is aware of a number of situations in which States awarded or planned to award a grant to one community, but the benefits of the activities would occur in a different community or throughout a much larger area. In some cases, one small community would receive a grant for an activity that would be carried out on a regional or even statewide basis. In other cases, suburban communities would receive funding for projects, and the principal benefit would accrue to a nearby Entitlement community. HUD does not believe it is appropriate for one community to serve as a "flag of convenience" grant recipient when only a small portion of the benefits will accrue to residents of that jurisdiction. In such situations, the more appropriate approach is for a State to make a grant to a "combination of governments," as is specifically provided for in the Act. In situations involving activities located in Entitlement communities, HUD believes it is appropriate for Entitlement communities to participate in funding such projects commensurate with the benefits their citizens receive.

This proposed rule would add to the existing regulations a requirement that reasonable benefits must accrue to residents within the jurisdiction of the grant recipient. Since HUD is aware that activities located outside a State grant recipient's jurisdiction may indeed provide substantial benefits to the citizens within the jurisdiction, this proposed rule would not prohibit such activities. The rule would simply require that the State grant recipient consider whom the funds will benefit; in making a determination that such a project meets the community's needs, the community should ensure that the benefits to its residents are sufficient to justify the project. HUD would not question the determination (or the State's acceptance thereof) unless it is clearly unreasonable. This proposed rule would not limit the amount or percentage of funds that may assist such an activity, and should not affect joint efforts by cities and counties to benefit their residents. The recipient would be responsible for determining the reasonableness of the benefits in such cases. A parallel change was recently finalized in the CDBG Entitlement regulations, in the November 9, 1995 final rule (60 FR 56892).

State Authority to Impose Additional Provisions

This proposed rule would add a new provision to reinforce States' administrative flexibility. This new

provision would authorize States to apply to participating units of general local government additional requirements or requirements that are more restrictive than those established by HUD. Such authority is implicit in the States' ability to administer the CDBG program, but HUD has never explicitly stated this in the regulations. States cannot impose any additional requirements that would be plainly inconsistent with the Act or with other statutory or regulatory provisions that apply to the State CDBG program. HUD proposes this provision in association with several of today's other proposed changes to portray more clearly State responsibilities and authority.

Findings and Certifications

Paperwork Reduction Act Statement

The information collection requirements in § 570.489(e)(4) of this proposed rule have been submitted to the Office of Management and Budget (OMB) for review under section 3507(d) of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a valid control number.

As required under 5 CFR 1320.8(d)(1), HUD and OMB are seeking comments from members of the public and affected agencies concerning the proposed collection of information to:

(1) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;

(2) Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information;

(3) Enhance the quality, utility, and clarity of the information to be collected; and

(4) Minimize the burden of the collection of information on those who are to respond; including through the use of appropriate automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses. Interested persons are invited to submit comments according to the instructions in the **DATES** and **ADDRESSES** sections in the preamble of this proposed rule.

This document also provides the following information:

Title of Proposal: Revisions to State CDBG Program Income Requirements and Miscellaneous Amendments.

OMB Control Number: HUD is seeking OMB approval for the information

collection requirements identified in this proposed rule. OMB will assign a control number for these State CDBG program information collection requirements upon granting approval. This proposed information collection would be in addition to the information collection requirements presently contained in the consolidated plan and covered under control number 2506-0117.

Description of the Need for the Information and Proposed Use: This rule proposes to revise the program income requirements governing the State CDBG program, along with miscellaneous other changes.

Form Numbers: Not applicable. No forms are required by HUD in the State CDBG program.

Members of Affected Public: States, units of general local government.

Estimation of the Total Number of Hours Needed to Prepare the Information Collection including Number of Respondents, Frequency of Response, and Hours of Response:

Changes in State CDBG requirements affect both State and local government staff. State staff review reports submitted by local governments, make on-site compliance reviews, and report to HUD on the uses of CDBG funds. Local government staff collect information to demonstrate compliance with program requirements and report to the State on the use of funds.

Two proposed changes in this rule would affect the amount of time spent by States and local governments in administering CDBG funds: locally-held program income subject to all CDBG requirements for as long as it exists; and States reporting on locally-held program income in their Consolidated Plan Reports. Several factors determine the burden that these proposed changes would impose on States and local governments. Housing rehabilitation and economic development activities are more likely to generate program income than are public facilities or public service activities. Activities that provide loans are more likely to generate program income than are activities providing grants or forgivable loans. The number, size, rate, and terms of loans made determine the amount of program income generated per year.

Some States require locally-retained program income to be used in compliance with some or all CDBG program income requirements, whether or not HUD's regulations require such compliance. In those States, the proposed rule will result in little or no additional local compliance burden. However, additional staff time will be needed by the States themselves to

report to HUD on the use of such program income.

The following figures represent additional increments of time and cost beyond those normally involved in the State CDBG program. In developing these estimates, HUD consulted with a representative sample of States; the figures represent a melding of HUD estimates with States' estimates to produce a national average.

All States together fund about 3,000 grants per year, consisting of about 11,000 activities. However, only about

20 percent of these activities are of types that are likely to generate income. As noted above, many of those income-generating activities are either not subject to program income requirements, or are already subject to program income requirements and will see no change under the proposed rule. Thus, HUD believes the number of State grants that will be subject to additional recordkeeping and reporting efforts is a relatively small portion of all State grants.

States make new grant awards to units of local government every year; however, States' grant contracts with units of general local government usually remain in force for several years. The burden estimates shown for local governments thus represent the net burden increase over the duration of its contractual relationship with the State, rather than annual figures. The burden estimates for States are average annual figures.

Burden of collection frequency	Number of respondents	Total hours per response	Total hours
Local recordkeeping and reporting to state on program income:			
Ongoing	550	60	33,000
State recordkeeping and reporting on program income:			
Annually	49	80	3,920
Total	599	36,920

Executive Order 12866

The Office of Management and Budget (OMB) reviewed this proposed rule under Executive Order 12866, *Regulatory Planning and Review*, issued by the President on September 30, 1993. OMB determined that this proposed rule is a "significant regulatory action," as defined in section 3(f) of the Order (although not economically significant, as provided in section 3(f)(1) of the Order). Any changes made in this rule subsequent to its submission to OMB are identified in the docket file, which is available for public inspection between 7:30 a.m. and 5:30 p.m. in the Office of the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC.

Environmental Impact

A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969. The Finding of No Significant Impact is available for public inspection during regular business hours in the Office of the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410.

Regulatory Flexibility Act

The Secretary, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)), has reviewed this proposed rule before publication and by approving it

certifies that this proposed rule does not have a significant economic impact on a substantial number of small entities. The proposed rule is limited to the effecting of relatively minor procedural amendments that would update the State CDBG regulations to recognize statutory amendments and clarify the regulations to address past confusion.

Executive Order 12612, Federalism

The General Counsel, as the Designated Official under section 6(a) of Executive order 12612, *Federalism*, has determined that the policies contained in this proposed rule will not have substantial direct effects on States or their political subdivisions, or the relationship between the Federal Government and the States, or on the distribution of power and responsibilities among the various levels of government. As a result, the proposed rule is not subject to review under the order. The proposed rule is limited to making relatively minor procedural amendments that would update the State CDBG regulations to recognize statutory amendments and clarify the regulations to address past confusion. In general, this proposed rule would provide more flexibility and clarity in the regulations for States and units of general local government.

Executive Order 12606, The Family

The General Counsel, as the Designated Official under Executive Order 12606, *The Family*, has determined that this proposed rule does not have potential for significant impact on family formation, maintenance, and general well-being, and, thus, is not subject to review under the order. No

significant change in existing HUD policies or programs will result from promulgation of this proposed rule, as those policies and programs relate to family concerns.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (UMRA) (Pub. L. 104-4, approved March 22, 1995; 109 Stat. 48) establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments and the private sector. This proposed rule would not impose any Federal mandates on any State, local, or tribal governments, or on the private sector within the meaning of the UMRA. The provisions of this proposed rule would primarily clarify program procedures or provide States additional flexibility in administering block grant funds.

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, Lead poisoning, Loan programs—housing and community development, Low and moderate income housing, New communities, Northern Mariana Islands, Pacific Islands Trust Territory, Pockets of poverty, Puerto Rico, Reporting and recordkeeping requirements, Small cities, Student aid, Virgin Islands.

Accordingly, for the reasons stated in the preamble, 24 CFR part 570 is proposed to be amended as follows:

PART 570—COMMUNITY DEVELOPMENT BLOCK GRANTS

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

Authority: 42 U.S.C. 5305(d) and 5300-5320.

2. Section 570.480 is amended by adding a new paragraph (e) to read as follows:

§ 570.480 General.

* * * * *

(e) A State may, in its administration of the program, apply additional or more restrictive provisions to units of general local government participating in the State's program, providing that such provisions are not plainly inconsistent with the Act or other statutory or regulatory provisions applicable to the State CDBG program.

3. Section 570.486 is amended by revising paragraph (b) to read as follows:

§ 570.486 Local government requirements.

* * * * *

(b) *Activities serving beneficiaries outside the jurisdiction of the unit of general local government.* CDBG-funded activities may serve beneficiaries outside the jurisdiction of the unit of general local government that receives the grant, provided that reasonable benefits from the activity will accrue to residents within the jurisdiction of the grant recipient, and provided that the unit of general local government determines that the activity is meeting its needs in accordance with section 106(d)(2)(D) of the Act (42 U.S.C. 5306(d)(2)(D)).

4. Section 570.489 is amended by:

- a. Revising paragraph (c);
- b. Revising paragraph (e);
- c. Revising the first sentence of paragraph (f)(2);
- d. Revising paragraphs (h)(2) and (h)(3);
- e. Adding a new paragraph (n); and
- f. Adding a new paragraph (o); to read as follows:

§ 570.489 Program administrative requirements.

* * * * *

(c) *Federal grant payments.* The State's requests for payment, and the Federal Government's payments upon such requests, must comply with 31 CFR part 205. The State must use procedures to minimize the time elapsing between the transfer of grant funds and disbursement of funds by the State to units of general local government. Units of general local government must also use procedures to minimize the time elapsing between the

transfer of funds by the State and disbursement for CDBG activities.

* * * * *

(e) *Program income.* (1) For the purposes of this subpart, "*program income*" is defined as gross income received by a State, a unit of general local government, or a subrecipient of a unit of general local government that was generated from the use of CDBG funds, except as provided in paragraph (e)(2) of this section. When income is generated by an activity that is only partially assisted with CDBG funds, the income must be prorated to reflect the percentage of CDBG funds used (e.g., a single loan supported by CDBG funds and other funds; a single parcel of land purchased with CDBG funds and other funds). Program income includes, but is not limited to, the following:

- (i) Proceeds from the disposition by sale or long term lease of real property purchased or improved with CDBG funds;
- (ii) Proceeds from the disposition of equipment purchased with CDBG funds;
- (iii) Gross income from the use or rental of real or personal property acquired by the unit of general local government or a subrecipient of a unit of general local government with CDBG funds, less the costs incidental to the generation of the income;
- (iv) Gross income from the use or rental of real property, owned by the unit of general local government or a subrecipient of a unit of general local government, that was constructed or improved with CDBG funds, less the costs incidental to the generation of the income;
- (v) Payments of principal and interest on loans made using CDBG funds, except as provided in paragraph (e)(2)(iv) of this section;
- (vi) Proceeds from the sale of loans made with CDBG funds, less legal and other costs associated with the sale of loans that are not otherwise eligible under sections 105(a)(13) or 106(d)(3)(A) of the Act (42 U.S.C. 5305(a)(13), 5306(d)(3)(A));
- (vii) Proceeds from the sale of obligations secured by loans made with CDBG funds, less legal and other costs associated with the sale of obligations that are not otherwise eligible under sections 105(a)(13) or 106(d)(3)(A) of the Act (42 U.S.C. 5305(a)(13), 5306(d)(3)(A));
- (viii) Interest earned on funds held in a revolving fund account;
- (ix) Interest earned on program income pending disposition of the income;
- (x) Funds collected through special assessments made against properties

owned and occupied by households not of low and moderate income, if the special assessments are used to recover all or part of the CDBG portion of a public improvement; and

(xi) Gross income paid to a unit of general local government or subrecipient from the ownership interest in a for-profit entity acquired in return for the provision of CDBG assistance.

(2) "*Program income*" does not include the following:

- (i) Any income received by a unit of general local government and its subrecipients during a twelve-month period, provided that the total of such income is less than \$25,000. (This provision does not apply to funds paid to the State for redistribution to other units of local government.)
- (ii) Amounts generated by activities that are eligible under section 105(a)(15) of the Act (42 U.S.C. 5305(a)(15)) and are carried out by an entity under the authority of section 105(a)(15) of the Act;
- (iii) Amounts generated by activities that are financed by a loan guaranteed under section 108 of the Act (42 U.S.C. 5308) and meet one or more of the public benefit criteria specified in § 570.482(f)(3)(v), or are carried out in conjunction with a grant under section 108(q) of the Act (42 U.S.C. 5308(q)) in an area determined by HUD to meet the eligibility requirements for designation as an Empowerment Zone or Enterprise Community pursuant to either 24 CFR part 597, subpart B or 7 CFR part 25, subpart B (as applicable). Such exclusion does not apply if CDBG funds are used to repay the guaranteed loan.

When such a guaranteed loan is partially repaid with CDBG funds, the amount generated must be prorated to reflect the percentage of CDBG funds used. Amounts generated by activities financed with loans guaranteed under section 108 of the Act (42 U.S.C. 5308) that are not defined as "*program income*" will be treated as miscellaneous revenue and will not be subject to any of the requirements of this part. However, such treatment does not affect the right of the Secretary to require the Section 108 borrower to pledge such amounts as security for the guaranteed loan. The determination whether such amounts constitute program income is governed by the provisions of the contract required at § 570.705(b)(1).

(iv) Payments of principal and interest made by a subrecipient to a unit of general local government, toward a loan from the local government to the subrecipient, when program income received by the subrecipient is being

used for such payments. (By making such payments, the subrecipient is deemed to have transferred program income to the unit of general local government.)

(v) Interest earned on the following; such interest must be remitted to HUD for transmittal to the U.S. Treasury, and will not be reallocated under section 106 (c) or (d) of the Act (42 U.S.C. 5306 (c), (d)):

(A) Interest earned on loans or other forms of assistance provided with CDBG funds that are used for activities determined by HUD either to be ineligible or to fail to meet a national objective in accordance with the requirements of §§ 570.482 or 570.483, or section 105(a) of the Act (42 U.S.C. 5305(a)), or that fail substantially to meet any other requirement of this subpart or the Act;

(B) Interest earned on the investment of amounts reimbursed to the CDBG program account prior to the use of the reimbursed funds for eligible purposes; and

(C) Interest earned by units of general local government on grant funds before disbursement of the funds for activities, except that the unit of general local government may keep interest payments of up to \$100 per year for administrative expenses and may deduct service charges for escrow accounts pursuant to paragraph (o) of this section. (Interest earned on lump sum deposits pursuant to paragraph (n) of this section is not subject to the provisions of paragraph (e)(2)(v)(C) of this section.)

(3) (i) *Program income paid to the State.* Except as described in paragraph (e)(3)(ii)(A) of this section, the State may require the unit of general local government that receives or will receive program income to return the program income to the State. Program income that is paid to the State is treated as additional CDBG funds subject to the requirements of this subpart. Except for program income retained and used by the State for administrative costs under § 570.489(a), program income paid to the State must be distributed to units of general local government in accordance with the method of distribution in the action plan under 24 CFR part 91 that is in effect at the time the program income is distributed. To the maximum extent feasible, the State must distribute program income before it makes additional withdrawals from the Treasury, except as provided in paragraph (f) of this section.

(ii) *Program income retained by a unit of general local government.* The State may permit the unit of general local government that receives or will receive program income to retain the program

income. In any case in which the State allows the unit of general local government to retain program income, the State may require the unit of local government to pay to the State an amount not to exceed 2 percent of the program income received, for use by the State in accordance with § 570.489(a).

(A) The State must permit the unit of general local government to retain the program income if the program income will be used to continue the activity from which it was derived.

(1) The State will determine when an activity will be considered to be continued. In making such a determination, the State may consider whether the unit of local government is or will be unable to comply with the requirements of paragraph (e)(3)(ii) of this section or other requirements of this part, and whether the program income-funded activity is unlikely to be completed within a reasonable time period.

(2) When the State determines that the program income will be used to continue the activity from which it was derived, but that the amount of program income held by the unit of local government exceeds projected cash needs for the near future, the State may require the local government to return all or part of the program income to the State's line of credit until such time as the program income is needed by the unit of general local government.

(B) Program income that is received and retained by the unit of general local government is treated as additional CDBG funds and is subject to all applicable requirements of this subpart for the duration of the program income's existence. The State has the option of selecting its approach for demonstrating compliance by units of local government with this paragraph (e)(ii)(B). The three approaches from which the State may select are:

(1) Maintaining contractual relationships with units of local government for the duration of the existence of the program income.

(2) Requiring advance State approval of either a State grant recipient's plan for the use of program income, or of each use of program income by grant recipients.

(3) With prior HUD approval, other approaches that demonstrate that the State will ensure compliance with the requirements of this subpart by units of local government.

(C) The provisions of paragraph (e)(3)(ii)(B) of this section apply to all activities funded with funds from fiscal year (FY) 1993 and later. All activities funded with FY 1992 and earlier funds are subject to § 570.489(e)(3)(ii) as it

existed immediately before [INSERT EFFECTIVE DATE OF FINAL RULE]. At its option, a State may apply the provisions of paragraph (e)(3)(ii)(B) of this section to FY 1992 and earlier funds.

(D) The State must require units of general local government, to the maximum extent feasible, to disburse program income that is subject to the requirements of this subpart before requesting additional funds from the State for activities, except as provided in paragraphs (f), (n), and (o) of this section.

(4) The State must report on the receipt and use of all program income (whether retained by units of local government or paid to the State) in its annual performance and evaluation report.

(f) * * *

(2) The State may establish one or more revolving funds to distribute funds to units of general local government throughout a State or a region of the State to carry out specific, identified activities. * * *

* * * * *

(h) * * *

(2) *Conflicts prohibited.* The general rule is that no persons described in paragraph (h)(3) of this section, who exercise or have exercised any functions or responsibilities with respect to CDBG activities assisted under this subpart or who are in a position to participate in a decisionmaking process or gain inside information with regard to such activities, may obtain a financial interest or benefit from the activity, or have a financial interest in any contract, subcontract, or agreement with respect thereto, or the proceeds thereunder, either for themselves or for those with whom they have immediate family or business ties, during their tenure or for one year thereafter.

(3) *Persons covered.* The conflict of interest provisions in paragraph (h)(2) of this section apply to any person who is an employee, agent, consultant, officer, or elected official or appointed official of the State, or of a unit of general local government, or of any designated public agencies, or subrecipients that are receiving funds under this part.

* * * * *

(n) *Lump sum drawdowns.* The requirements for States and units of general local government regarding lump sum drawdowns to finance property rehabilitation activities are in § 570.513.

(o) *Use of escrow accounts for rehabilitation of privately owned residential property.* The requirements for States and units of general local

government regarding the use of escrow accounts for rehabilitation of privately owned residential property are in § 570.511.

5. Section 570.511 is revised to read as follows:

§ 570.511 Use of escrow accounts for rehabilitation of privately owned residential property.

(a) *Limitations.* A recipient may withdraw funds (or, as applicable, a State may allow units of general local government to withdraw funds) from its letter of credit for immediate deposit into an escrow account for use in funding loans and grants for the rehabilitation of privately owned residential property. The following limitations apply to the use of escrow accounts for residential rehabilitation loans grants closed after September 7, 1990. (For the State CDBG program, the following limitations apply to the use of escrow accounts for residential rehabilitation loans and grants closed after [INSERT EFFECTIVE DATE OF FINAL RULE]):

(1) The use of escrow accounts under this section is limited to loans and grants for the rehabilitation of primarily residential properties containing no more than four dwelling units (and accessory neighborhood-scale nonresidential space within the same structure, if any, e.g., a store front below a dwelling unit).

(2) An escrow account must not be used unless the contract between the property owner and the contractor selected to do the rehabilitation work specifically provides that payment to the contractor shall be made through an escrow account. No deposit to the escrow account can be made until after the contract has been executed between the property owner and the rehabilitation contractor.

(i) For the CDBG Entitlement program, the escrow account must be maintained by the recipient, by a subrecipient as defined in § 570.500(c), by a public agency designated under § 570.501(a), or by an agent under a procurement contract governed by the requirements of 24 CFR 85.36.

(ii) For the State CDBG program, the escrow account must be maintained by the unit of general local government, by an agent under a procurement contract governed by the requirements of § 570.489(g), or by a nonprofit entity authorized under section 105(a)(15) of the Act (42 U.S.C. 5305(a)(15)).

(3) All funds withdrawn under this section must be deposited into one interest earning account with a financial institution. Separate bank accounts may

not be established for individual loans and grants.

(4) The amount of funds deposited into an escrow account must be limited to the amount expected to be disbursed within 10 working days from the date of deposit. If the escrow account, for whatever reason, at any time contains funds exceeding 10 days' cash needs, the recipient must immediately transfer (or, as applicable, the State must ensure that a unit of general local government immediately transfers) the excess funds to its program account. In the program account, the excess funds must be treated as funds erroneously drawn in accordance with the requirements of U.S. Treasury Financial Manual, paragraph 6-2075.30.

(5) Funds deposited into an escrow account must be used only to pay the actual costs of rehabilitation incurred by the owner under the contract with a private contractor. Other eligible costs related to the rehabilitation loan or grant, e.g., the recipient's (or, as applicable, the unit of general local government's) administrative costs (as defined for the Entitlement CDBG program under § 570.206) or rehabilitation services costs under § 570.202(b)(9) if applicable, are not permissible uses of escrowed funds. Such other eligible rehabilitation costs must be paid under normal CDBG payment procedures (e.g., from withdrawals of grant funds under the recipient's (or State's, as applicable) letter of credit with the Treasury).

(b) *Interest.* Interest earned on escrow accounts established in accordance with this section, less any service charges for the account, must be remitted to HUD (for transmittal to the U.S. Treasury) at least quarterly but not more frequently than monthly. Interest earned on escrow accounts is not required to be remitted to HUD to the extent the interest is attributable to the investment of program income.

(c) *Remedies for noncompliance.* If HUD determines that a recipient has failed (or, as applicable, if a State determines that a unit of general local government has failed) to use an escrow account in accordance with this section, HUD may, in addition to imposing any other sanctions provided for under this part, require the recipient to discontinue the use of escrow accounts, in whole or in part (or, as applicable, the State may, under the authority of § 570.492(b), require the unit of general local government to discontinue the use of escrow accounts, in whole or in part).

6. Section 570.513 is revised to read as follows:

§ 570.513 Lump sum drawdown for financing of property rehabilitation activities.

Subject to the conditions prescribed in this section (and section 104(h) of the Act (42 U.S.C. 5304(h), as applicable)), recipients may draw down funds (or, as applicable, States may allow units of general local government to draw down funds) from the letter of credit in a lump sum to establish a rehabilitation fund in one or more private financial institutions for the purpose of financing the rehabilitation of privately owned properties. The fund may be used in conjunction with various rehabilitation financing techniques, including loans, interest subsidies, loan guarantees, loan reserves, or such other uses as may be approved by HUD consistent with the objectives of this section. The fund may also be used for making grants, but only for the purpose of leveraging non-CDBG funds for the rehabilitation of the same property.

(a) *Limitation on drawdown of grant funds.* (1) The funds that a recipient deposits (or, as applicable, that a State allows a unit of general local government to deposit) to a rehabilitation fund must not exceed the grant amount that the recipient (or State, as applicable) reasonably expects will be required, together with anticipated program income from interest and loan repayments, for the rehabilitation activities during the period specified in the agreement with the financial institution(s) (described in paragraph (b)(2) of this section), based on:

(i) Prior level of rehabilitation activity; or

(ii) Rehabilitation staffing and management capacity during the period specified in the agreement to undertake activities; or

(iii) For purposes of the State CDBG program only, estimated demand for rehabilitation activity.

(2) No grant funds may be deposited under this section solely for the purpose of investment, notwithstanding that the interest or other income is to be used for the rehabilitation activities.

(3) The recipient's (or, as applicable, the unit of general local government's) rehabilitation program administrative costs and the administrative costs of the financial institution may not be funded through lump sum drawdown. Such costs must be paid from periodic letter of credit withdrawals in accordance with standard procedures or from program income, other than program income generated by the lump sum deposit.

(b) *Standards to be met.* The following standards apply to all lump

sum drawdowns of CDBG funds for rehabilitation:

(1) *Eligible rehabilitation activities.* The rehabilitation fund must be used to finance the rehabilitation of privately owned properties (including the acquisition of properties for rehabilitation) eligible under the general policies in § 570.200, if applicable, and the specific provisions of either § 570.202 or § 570.203, if applicable; or, for purposes of the State CDBG program, as eligible under section 105 (a)(4), (a)(5), (a)(14), (a)(15) or (a)(17) of the Act (42 U.S.C. 5305(a)).

(2) *Requirements for agreement.* The recipient (or unit of general local government, as applicable) must execute a written agreement with one or more private financial institutions for the operation of the rehabilitation fund. The agreement must specify the obligations and responsibilities of the parties, the terms and conditions on which CDBG funds are to be deposited and used or returned, the anticipated level of rehabilitation activities by the financial institution, the rate of interest and other benefits to be provided by the financial institution in return for the lump sum deposit, and such other terms as are necessary for compliance with the provisions of this section. Except for purposes of the State CDBG program, upon execution of the agreement, the recipient must provide a copy to the HUD field office for its records and use in monitoring; the recipient must also provide to HUD any modifications made during the term of the agreement. For purposes of the State CDBG program, a State may require State approval of any local agreement or modification.

(3) *Period to undertake activities.* The agreement must be fully executed before the lump sum deposit is made. Except for purposes of the State CDBG program, the agreement must provide that the rehabilitation fund may only be used for authorized activities during a period of no more than two years. For purposes of the State CDBG program, States may set maximum time limits on the duration of lump sum drawdown agreements, but in no case can an agreement remain in effect after the date that a grant to a unit of general local government is closed out; the agreement must specify the time period for which the agreement is in effect.

(4) *Time limit on use of deposited funds.* (This paragraph (b)(4) of this section does not apply to the State CDBG program). Use of the deposited funds for rehabilitation financing assistance must start (e.g., first loan must be made, subsidized or guaranteed) within 45 days of the deposit. In addition, substantial

disbursements from the fund must occur within 180 days of the receipt of the deposit. (Where CDBG funds are used as a guarantee, the funds that must be substantially disbursed are the guaranteed funds.) For a recipient with an agreement specifying two years to undertake activities, the disbursement of 25 percent of the fund (deposit plus any interest earned) within 180 days will be regarded as meeting this requirement. If a recipient with an agreement specifying two years to undertake activities determines that it has had substantial disbursement from the fund within the 180 days although it had not met this 25 percent threshold, the justification for the recipient's determination must be included in the program file. If a recipient does not start using the funds within 45 days, or substantial disbursement from such fund does not occur within 180 days, the recipient may be required by HUD to return all or part of the deposited funds to the recipient's letter of credit.

(5) *Program activity.* Recipients (or States, as applicable) must review the level of program activity under each agreement on a yearly basis. If activity is substantially below that anticipated, the recipient must return program funds to its letter of credit (or the State must require that the unit of general local government return program funds to the State's letter of credit, as applicable).

(6) *Termination of agreement.* (i) In the case of substantial failure by a private financial institution to comply with the terms of a lump sum drawdown agreement under the Entitlement CDBG program, the recipient must terminate its agreement, provide written justification for the action, withdraw all unobligated deposited funds from the private financial institution, and return the funds to the recipient's letter of credit.

(ii) For purposes of the State CDBG program, a State must develop and implement standards to ensure that, in cases of substantial failure by a private financial institution or a unit of general local government to comply with the terms of a lump sum drawdown agreement, all unobligated deposited funds will be withdrawn from the private financial institution and returned to the State's letter of credit.

(7) *Return of unused deposits.* At the end of the period specified in the agreement for undertaking activities, all unobligated deposited funds must be returned to the recipient's (or State's, as applicable) letter of credit unless the recipient (or unit of general local government, as applicable) enters into a new agreement conforming to the requirements of this section. In

addition, the recipient (or State, as applicable) must reserve the right to withdraw any unobligated deposited funds as required by HUD (or, for purposes of the State CDBG program, as determined by HUD or the State) in the exercise of corrective or remedial actions authorized under §§ 570.910(b), 570.911, 570.912, or 570.913 (or, for purposes of the State CDBG program, under this section, §§ 570.492, 570.493, 570.495, or 570.496).

(8) *Rehabilitation loans made with non-CDBG funds.* If the deposited funds or program income derived from deposited funds are used to subsidize or guarantee repayment of rehabilitation loans made with non-CDBG funds, or to provide a supplemental loan or grant to the borrower of the non-CDBG funds, the rehabilitation activities are considered to be CDBG-assisted activities subject to the requirements applicable to such activities, except that repayment of non-CDBG funds is not treated as program income.

(9) *Provision of consideration.* In consideration for the lump sum deposit by the recipient (or unit of general local government, as applicable) in a private financial institution, the deposit must result in appropriate benefits in support of the recipient's (or, as applicable, unit of general local government's) rehabilitation program. Minimum requirements for such benefits are:

(i) Recipients (or units of general local government, as applicable) must require the financial institution to pay interest on the lump sum deposit.

(A) The interest rate paid by the financial institution cannot be lower than three points below the rate on one-year Treasury obligations at constant maturity.

(B) When an agreement sets a fixed interest rate for the entire term of the agreement, the rate should be based on the rate at the time the agreement is executed.

(C) The agreement may provide for an interest rate that would fluctuate periodically during the term of the agreement, but the established rate cannot be lower than three points below the rate on one-year Treasury obligations at constant maturity.

(ii) In addition to the payment of interest, the financial institution must provide at least one of the following benefits:

(A) Leverage of the deposited funds so that the financial institution commits private funds for the loans in the rehabilitation program in an amount substantially in excess of the amount of the lump sum deposit;

(B) Commitment of private funds by the financial institution for

rehabilitation loans at below market interest rates, at higher than normal risk, or with longer than normal repayment periods; or

(C) Provision of administrative services in support of the rehabilitation program by the participating financial institution at no cost or at lower than actual cost.

(c) *Program income.* Interest earned on lump sum deposits and payments on loans made from such deposits are program income and, during the period of the agreement, must be used for rehabilitation activities under the provisions of this section.

(d) *Outstanding findings.* Notwithstanding any other provision of

this section, a recipient may not enter into a new agreement (or, as applicable, a State may not allow a unit of general local government to enter into a new agreement) during any period of time in which an audit or monitoring finding on a previous lump sum drawdown agreement remains unresolved.

(e) *Prior notification.* (This paragraph (e) of this section does not apply to the State CDBG program.) The recipient must submit written notification to the HUD field office of the amount of funds to be deposited with a private financial institution, before making the deposit under the provisions of this section.

(f) *Recordkeeping requirements.* (This paragraph (f) of this section does not apply to the State CDBG program.) The recipient must maintain in its files a copy of the written agreement and related documents establishing conformance with this section and concerning performance by a financial institution in accordance with the agreement.

Dated: March 5, 1997.

Howard Glaser,

Acting Assistant Secretary for Community Planning and Development.

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