Announcement 06-02 March 13, 2006

Amends these Guides: Selling

Enhancements to the Community Seconds® Option

The Community Seconds option combines a first mortgage that Fannie Mae purchases with a subordinate mortgage. The subordinate mortgage may be funded by a state, county, or local housing agency, a nonprofit organization, or an employer; it may be used to finance the down payment and/or closing costs. The specific terms and structures that are associated with Community Seconds may vary depending upon the provider. Fannie Mae does not purchase Community Seconds mortgages; however, for first mortgages delivered to us, we provide the eligibility requirements for the subordinate Community Seconds mortgage.

Fannie Mae’s Community Seconds option supports affordable housing partnerships among government entities, nonprofit organizations, lenders, and employers in a community. This option enables government entities, nonprofit organizations, and employers to leverage the limited public, nonprofit, or corporate funds they have earmarked for homeownership programs for subordinate mortgages to help more families achieve homeownership.

This Announcement includes several changes to Fannie Mae’s Selling Guide that clarify or amend our current requirements for Community Seconds. The changes discussed in this Announcement include some that will take effect immediately and others that, due to necessary system enhancements, will take effect later in 2006.

Changes Effective Immediately

Following is a list of Community Seconds enhancements that are effective immediately. These changes apply to all Community Seconds:

- simplification of the documentation required to confirm that the Community Seconds mortgage is subordinate to the first mortgage delivered to Fannie Mae;
• elimination of the “list” of acceptable default conditions that Community Seconds providers may incorporate in their documents;
• relaxation of the maximum interest rate guideline on the second mortgage; and
• elimination of additional program requirements when the combined loan-to-value ratio exceeds 100 percent.

Any guidelines or requirements in the Selling Guide that are not addressed in this Announcement will remain unchanged, including the requirement that lenders must be eligible to deliver first mortgages with a Community Seconds mortgage.

Subordination Language

Part VIII: Community Lending Mortgages; Chapter 2, Community Seconds Option; Section 202.01, Review of Legal Documents. This section of the Selling Guide is modified to state that the Community Seconds documents do not need to explicitly state the fact that the Community Second mortgage will be subordinate to the first mortgage. The title insurance policy must ensure the priority of the first mortgage being delivered to Fannie Mae by showing the Community Seconds mortgage in a subordinate position.

Default Conditions

Part VIII: Community Lending Mortgages; Chapter 2, Community Seconds Option; Section 202.01, Review of Legal Documents. This section of the Selling Guide is modified to state that we no longer will specify allowable conditions for default on Community Seconds mortgages and will leave that to the discretion of the Community Seconds provider.

Interest Rate

Part VIII: Community Lending Mortgages; Chapter 2, Community Seconds Option; Section 203.02, Nullification (or Amendment) of Unacceptable Terms. The interest rate on the subordinate mortgage has, until now, been capped to not exceed the interest rate on the first mortgage. This section is modified to state that we will permit the interest rate on the subordinate mortgage to be up to two percentage points higher than the interest rate on the first mortgage. The subordinate loan payments must continue to be included in the debt-to-income calculations at the time of underwriting (if payments commence within the first five years).

Additional Program Requirements When the Combined Loan-To-Value Ratio Exceeds 100 Percent

Part VIII: Community Lending Mortgages; Chapter 2, Community Seconds Option; Section 204, Higher Allowable Combined Loan-to-Value Ratio. When a first mortgage is originated with a Community Seconds mortgage, the combined loan-to-value ratio for the mortgage and the subordinate financing may be as high as 105 percent. The Community Seconds option currently has in place certain borrower relief provisions for mortgages with combined loan-to-value ratios that exceed 100 percent. The provisions require relief for some (or all) of the subordinate mortgage obligation if the borrower suffers a catastrophic event (such as
the borrower's death or divorce or an extended illness of the borrower or a close family member who depends primarily on the borrower for support) that results in the property having to be sold. We are eliminating these requirements in favor of the relief provisions, if any, chosen by the provider of the subordinate mortgage. Our loan-to-value (LTV) will continue to be capped based on the underlying first mortgage product, and the combined loan-to-value (CLTV) will remain capped at 105 percent.

**Desktop Underwriter® Loans**

Effective immediately, these enhancements also apply to loans underwritten with Desktop Underwriter (DU). DU will be updated later this year to reflect these changes. In the meantime, until the enhancements are implemented in DU, lenders may apply these enhancements to DU loans and disregard outdated portions of DU messages regarding Community Seconds.

**Loan Product Eligibility to be Expanded Later**

Currently, the first mortgage must be originated as one of Fannie Mae's community lending mortgage products (Community Home Buyer's Program™, Fannie 97®, Fannie 3/2®, or MyCommunityMortgage™), Flexible 97®, or Flexible 100™. We are working to expand the list of products that may be used with the Community Seconds option. The additional products will include all community lending and non-community lending fixed-rate and adjustable-rate products (with the exception of ARMs with an initial fixed-rate period of less than 5 years, mortgages with the potential for negative amortization, InterestFirst™, and Home Keeper®). For products outside of the community lending umbrella:

- The transaction is limited to a purchase or limited-cash out refinance¹ (cash-out refinances are not eligible).
- Only principal residences are eligible (second homes and investment properties are not eligible).
- If the product is secured by a manufactured home, the loan must comply with all manufactured home policies, including the LTV and CLTV ratios.
- The maximum LTV of the underlying product remains unchanged.
- CLTV can be expanded to 105 percent, regardless of the CLTV required for the underlying product, provided the subordinate financing meets all conditions of a Community Seconds mortgage and the base product does not have a conditional lower CLTV limit (e.g., if non-DU underwritten, manufactured housing, etc.).
- The borrower must continue to meet borrower eligibility criteria for community lending programs. However, the existing Community Seconds income exception for housing finance agencies, nonprofits, or employers (i.e. the income limits that these organizations have imposed) will apply.

¹ For a limited cash-out transaction, the subordinate mortgage holder must acknowledge the lien position by executing a subordination agreement which must be recorded if required to ensure enforceability.
Because of required system enhancements, we will not be able to accept delivery of these additional products with Community Seconds at this time. We are providing these specifics to enable lenders to begin working on any internal system changes that may be required. When we are ready to accept these additional products later this year, we will issue an Announcement as well as DU Release Notes.

Tracking of Community Seconds

Lenders must supply the Special Feature Code (SFC) 118 on all loans delivered with the Community Seconds option. Lenders are also required to provide the subordinate mortgage amount and the monthly principal and interest payment for the subordinate mortgage so that the CLTV and monthly housing expense ratios are accurately reported. *(Note: When the subordinate mortgage requires a periodic payment, the monthly payment must be included in the calculation of the borrower’s debt-to-income ratios, unless the payments are deferred for five years or more.)*

When Fannie Mae’s delivery system is updated later in 2006, any first mortgage being delivered with a Community Seconds mortgage (SFC 118) must be delivered with the subordinate mortgage amount included in the calculation of the CLTV.

Community Seconds are identified in DU by the use of the Community Seconds indicator on the Community Lending screen. Until now, that indicator could only be used when the first mortgage is a Community Lending product. When DU is updated later this year, DU will allow the selection of this option for all products eligible to use the Community Seconds option.

Evaluation of Community Seconds

Lenders that have been approved to deliver community lending products may continue to approve the subordinate mortgage programs that are used in those transactions in accordance with our requirements for such transactions. The checklist used to evaluate key considerations in determining whether to grant approval of a subordinate mortgage program has been updated and is attached to this Announcement (Attachment 1).

In instances when the subordinate mortgage program does not comply with our requirements, it is still possible for the lender to deliver first mortgages that are subject to subordinate financing under that subordinate mortgage program if, for each individual transaction, the borrower and the subordinate mortgage provider sign a Rider to the Subordinate Mortgage (Deed of Trust) to indicate their agreement to the changes required to amend or nullify the terms of the subordinate mortgage program to make it consistent with our requirements. The sample Rider to the Second Mortgage (Deed of Trust) that is attached to this Announcement (Attachment 2) sets out the Fannie Mae terms and conditions that will supersede those in the second mortgage document. Lenders must revise the format and contents of this model Rider, as applicable, to comply with specific state law(s) and make appropriate completions regarding the particular transaction.
Lenders should contact their Customer Account Team if they have any questions about the topics addressed in this Announcement.

Pamela S. Johnson
Senior Vice President

Attachments (2)
Attachment 1

Part VIII: Chapter 2, Exhibit 1 Community Seconds Checklist (03/13/06)

A Community Seconds provider or a lender may use this checklist to determine whether a subordinate mortgage program complies with Fannie Mae's guidelines for Community Seconds. Each section of the checklist is cross-referenced to the applicable section of Fannie Mae Selling Guide in Part VIII Chapter 2.

• If the answer to each of the following questions is "No," the subordinate mortgage program complies with our guidelines, and the related first mortgage may be delivered to Fannie Mae—provided the first mortgage lender determines that the mortgage otherwise satisfies Fannie Mae's mortgage eligibility criteria and underwriting guidelines.

• If the answer to any of the following questions is "Yes," the subordinate mortgage program is not automatically excluded from consideration. The provider may contact a Fannie Mae-approved community lending lender to determine whether its particular program includes features that, in certain instances, might be considered acceptable.

CHECKLIST QUESTIONS

1. **Down Payment (Section 201).** Is the minimum borrower contribution required by the program less than what is required under the terms of the first mortgage?
   
   Yes ____ No ____

2. **Evaluation of Subordinate Mortgage Program (Section 202).** Will the subordinate mortgage documents constitute a lien that is a prior lien to the first mortgage?
   
   Yes ____ No ____

3. **Review of Legal Documents (Section 202.01).** Are there any covenants or restrictions recorded against the property (including, but not limited to, provisions in the subordinate mortgage documents) that restrict the use and resale of the property, and which do not otherwise comply with Fannie Mae’s policies on resale restrictions?
   
   Yes ____ No ____
4. **Shared Appreciation in Property Value (Section 203.01).** If the subordinate mortgage provides for the provider to share in any appreciation in the value of the property, does the provider's share exceed the percentage calculated by dividing the original principal balance of the subordinate mortgage by the value of the property (as it was determined in connection with the origination of the first mortgage)?
   
   Yes ____ No ____

5. **Shared Appreciation in Property Value (Section 203.01).** If the subordinate mortgage provides for the provider to share in any appreciation in the value of the property, is interest also charged on the subordinate mortgage?
   
   Yes ____ No ____

6. **Balloon Payment (Section 203.02).** Does the subordinate mortgage provide for a payment that (1) is larger than the periodic payment required to amortize the subordinate loan and (2) becomes due and payable before the maturity date of the first mortgage, i.e., a balloon payment?
   
   Yes ____ No ____

7. **Interest Rate (Section 203.02).** If interest is charged on the subordinate mortgage, is the rate higher than two percentage points above the interest rate of the first mortgage?
   
   Yes ____ No ____

8. **Negative Amortization (Section 203.02).** Does the subordinate mortgage provide for negative amortization (accrual of interest during a period when payments on the loan are otherwise deferred)?
   
   Yes ____ No ____

9. **Higher Allowable Combined Loan-to-Value Ratio (Section 204).** Does the combined loan-to-value ratio for the first and subordinate mortgages exceed 105 percent?
   
   Yes ____ No ____
Part IV: Chapter 5, Exhibit 4 Fannie Mae’s Community Seconds Rider (03/13/06)

This following is a sample document only. The first mortgage lender must (1) revise this document as to format and content to comply with applicable state law, and (2) make appropriate completions regarding the particular transaction. As drafted, this document is not in executable form.

RIDER

This Rider, dated ____________, ____ , is an amendment to that certain subordinate Mortgage, Deed of Trust, or Security Deed (the “Security Instrument”), of the same date, given by the undersigned (the “Borrower”) to secure Borrower’s promissory note (the “Subordinate Note”) to ______________________________ (the “Subordinate Lender”) of the same date and covering the property described in the Security Instrument and located at ______________________________ [Property Address] (the “Property”).

The loan evidenced by the Security Instrument and the Subordinate Note is referred to herein as the “Subordinate Loan.”

WHEREAS, the Borrower has applied and been approved for a first lien loan (the “First Lien Loan”) to be originated by ___________________________________________ (the “First Lien Lender”) and intended to be sold to Fannie Mae. The First Lien Loan is secured by the Property;

WHEREAS, certain terms of the Subordinate Loan may conflict with Fannie Mae’s guidelines for subordinate financing that may be utilized in connection with first mortgage loans eligible for its purchase;

WHEREAS, the Borrower and the Subordinate Lender desire to amend the Security Instrument and the Subordinate Note in order to bring said documents into compliance with Fannie Mae guidelines for subordinate financing, all as more fully set forth below.

NOW THEREFORE, in consideration of the foregoing premises and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows:

1. Notwithstanding anything to the contrary contained in the Security Instrument and the Subordinate Note, the following terms govern the Security Instrument and the Subordinate Note:

   A. To the extent that the amount of the Subordinate Loan causes the combined loan-to-value of the Subordinate Loan and the First Lien Loan to exceed 105 percent, the Subordinate Note is hereby amended to provide that such excess is considered debt that is not secured by the Security Instrument.

   B. If negative amortization (e.g., interest that accrues during a period of principal and/or interest payment deferral) on the Subordinate Loan is otherwise
provided by the terms of the Subordinate Note or the Security Instrument, such provision is nullified by this Rider.

Notwithstanding the foregoing, if the Subordinate Loan provides for the deferred payment of some or all of the accrued interest, such provision is not nullified to the extent: (i) interest is accrued on a simple-interest basis at a rate that is not more than 75 percent of the rate of the related First Lien Loan, and the accrued interest is fully deferred until (a) sale or transfer of the Property, (b) cash-out refinance, limited cash-out refinance, or other full repayment of the First Lien Loan, or (c) declaration of an event of default under the Subordinate Note or the Security Instrument; or (ii) the accrued interest is assessed only as a penalty upon declaration of an event of default under the Subordinate Note or the Security Instrument.

C. If interest is charged on the Subordinate Loan and the rate is more than 2% higher than the rate of the First Lien Loan, the interest rate on the Subordinate Note is reduced to equal the rate of the First Lien Loan plus 2%, except in connection with penalty interest as described in paragraph 1.B.(ii) above.

D. If the Subordinate Loan provides for payment of a stated rate of interest, the terms of the Subordinate Loan may not also allow the Subordinate Lender, as a supplemental means of payment, to share in the appreciation of the value of the Property. In the event the Subordinate Loan does provide for both a stated rate of interest as well as a share in the appreciation of the value of the Property, the Subordinate Lender may elect, at its option, either, but not both, of these methods of payment.

E. If the terms of the Subordinate Loan provide for the Subordinate Lender to share in the appreciation of the value of the Property, any share to which the Subordinate Lender is otherwise entitled is nullified by this Rider to the extent that such share exceeds an amount equal to the principal amount of the Subordinate Note divided by the original sales price of the Property, multiplied by the value of the Property; provided, however, the value of the Property will be determined from, as applicable: (i) a bona fide arm’s length sale; (ii) a bona fide independent appraisal; or (iii) the final, successful bid for the Property entered at a foreclosure sale. Subject to the rights of the First Lien Lender, the Borrower is entitled to the balance of the appreciation, after deduction of the Subordinate Lender’s share.

Notwithstanding the foregoing, if the terms of the Subordinate Loan provide for a share of appreciation to which the Subordinate Lender is entitled that exceeds the share described in the paragraph above, such terms are not nullified by this Rider if such terms provide for either of the following: (i) the share of the Subordinate Lender is subject to reduction to allow the Borrower to recover, as a minimum, the sum of (a) the amount of the down payment contributed from the Borrower’s own resources, (b) that portion of the
aggregate of payments made by the Borrower on the First Lien Loan that are allocated to principal rather than interest, (c) the Borrower’s reasonable costs of sale of the Property (including, but not limited to, real estate broker’s commission), and (d) the cost of improvements made by the Borrower to the Property (to the extent such improvements were allowed pursuant to the guidelines of the Subordinate Lender); or (ii) the share of the Subordinate Lender does not exceed 75 percent at the origination of the Subordinate Loan, and the share of the Subordinate Lender is thereafter reduced over time so that no later than five years after origination of the Subordinate Loan, the share of the Subordinate Lender would not exceed the share described in the paragraph above.

F. If the Subordinate Loan is a balloon mortgage, any scheduled maturity that is prior to the maturity of the First Lien Loan is nullified by this Rider, and the maturity date of the First Lien Loan is established as the maturity date of the Subordinate Loan.

2. Nothing herein invalidates, impairs or releases any covenant, condition, agreement or stipulation in the Subordinate Note or the Security Instrument and the same, except as herein modified, continue in full force and effect. The Borrower further covenants and agrees to perform and comply with and abide by each of the covenants, agreements, conditions and stipulations of the Subordinate Note and the Security Instrument as modified herein.

3. This Rider is binding on and inures to the benefit of the heirs, executors, administrators and assigns, or successors and assigns of the respective parties hereto.

4. The terms of this Rider govern in the event of any conflict between the terms of this Rider and the terms of the Subordinate Loan. Any conflicting provision of the terms of the Subordinate Loan is superseded by the related provision of this Rider.

IN WITNESS WHEREOF, this Rider has been duly executed by the parties hereto the day and year first above written.

Witness:

SUBORDINATE LENDER:

BY: ________________________________

Witness:

BORROWER

BY: ________________________________