

**Recommendations Regarding HUD's Proposed Changes
FHA Multifamily Mortgage Insurance Programs
Underwriting Requirements
March 2010**

Background

HUD is proposing significant changes to its multifamily mortgage insurance programs because it is concerned about rising defaults in the FHA multifamily loan portfolio. HUD reports that claim rates have increased from 0.6 percent in FY2007 to 1.2 percent in FY2009. HUD further reports that Hub directors, in reviewing their portfolios, project claim/partial payment of claim rates of 2.4 percent in FY2010. HUD says market-rate loans are showing the greatest signs of distress and points out that it has a concentration of market rate properties in high vacancy markets. Although no programs will be shut down per se, taken together, the changes would cause many borrowers to not move forward and either return their properties to the current lender or not start construction. This will cause the direct loss of many jobs and deny many cities a much needed addition to their tax base.

Our organizations believe that many of HUD's insurance claims are due to recent global economic stress and not program underwriting procedures. This is proven by the fact that the claims are concentrated in markets undergoing the greatest economic stress such as Nevada, Arizona and Florida and that they are for properties underwritten before the current economic recession manifested itself. Now, as the economy is struggling to recover, we do not believe it is appropriate to further hamstring the very programs that are doing the most to spur economic development and create jobs. Certainly, additional restraints should be exercised by the Hubs located in markets which are under stress due to unprecedented economic difficulties, but we feel strongly that the program is less at fault than the economy and that there are enough existing tools to allow field offices to refuse projects or extend operating deficit reserves to handle their respective markets.

In particular, the market rate Section 221(d)(4) and market rate Section 223(f) programs are the longest running and best thought out programs in the HUD portfolio. By altering long-standing policy to address today's temporary economic conditions, HUD is leaving the Department in a position where it will have severely impaired the very programs that have worked well for half a century.

Early in the new administration, HUD committed to continuing to provide support for the multifamily rental finance system. HUD quickly took steps to institute a waiver of the three-year rule for refinancings, with certain conditions, and extended that waiver twice (the second extension just recently and for one year, rather than six months). HUD also instituted a waiver to allow projects already under construction, with certain conditions, to apply for FHA financing. We supported both moves and commended HUD for its actions in this regard.

However, although the economic and financial climates have begun a slow recovery, sources of financing for multifamily other than FHA (for existing and new construction properties) and Fannie Mae and Freddie Mac (for refinancing existing properties only) are virtually out of the

market, including CMBS, conduits, pension funds, insurance companies and banks. In addition, Fannie Mae and Freddie Mac have tightened lending requirements steadily over the last 18 months in response to market conditions (declining rent revenue, increased vacancies, falling real estate values) due to the fact that their programs focus on the existing housing stock. FHA is the only source of affordable financing for new construction at this time.

Under HUD's new proposals, many new deals and pending deals will simply not be built. Several factors create this imbalance: (1) a shortage of traditional equity sources; (2) complete withdrawal of institutional equity; (3) current HUD rules are already restrictive; and (4) actual equity is more than "program equity." The latter point is important because the Sponsor has to pay a developer fee, contractor profit, offsite escrow, working capital escrow and operating deficit escrow, all of which typically equal more than the Builder's and Sponsor's Profit and Risk Allowance (BSPRA). We are aware of a recent transaction where the mortgage amount was restricted only by cost (so DSC is irrelevant), and these additional costs/equity equaled about 15 percent of total costs; therefore, the 90 percent LTC mortgage became 85 percent LTC.

HUD's proposed changes will cause a halt to production of needed multifamily housing and will further depress the construction employment sector, which has already lost over 2,000,000 jobs. The loss of production will result in higher rents in 2012 and beyond, due to pent up demand from the lack of supply.

We believe that HUD should take a longer term view of its role in the marketplace. Historically, HUD has been the lender of last resort because of lengthy processing times, high fees, onerous rules and painstaking oversight. As in the single family programs, this leads to the Department attracting lesser quality deals, except in very tough times, such as currently. HUD now has the opportunity to improve its default rates because the more recent applications include more Class A properties than typical. This is not the time to further restrict the only remaining source of capital for multifamily loans.

Our organizations have long-supported the FHA multifamily mortgage insurance programs and supports HUD's efforts to improve the programs. However, we find differences with HUD as set forth in our comments below. We look forward to working with the Department to ensure that FHA financing for multifamily rental housing remains affordable and available during this difficult economic environment. Please note that we have given primary focus to those matters which affect the Borrower/ Sponsor and left the matters relating to Lenders to the MBA.

New Policy on Oversight

Borrower reviews will be tightened to include the following:

Analysis of sponsor's and key principal's REO schedule

We ask for more information on this proposal. HUD receives extensive information about the sponsor from the 2530, which already exceeds any review being required in the private sector. Mortgage credit reviews address the financial capability of the key principal. What additional information is being sought?

Contingent liability for key principals who must sign and take responsibility for “bad boy” acts of the mortgagor entity

We do not support the imposition of a review of contingent liabilities beyond what is currently required. We also understand this is pending as a proposed change to the multifamily loan closing documents, and we oppose it in that context as well. In addition, we understand that such a change would require a rulemaking.

Additional review for any key principal (concentration of over \$250 million)

We support this proposal.

New requirements for mortgagees (net worth, specialty certification for lenders and underwriters for new construction or LIHTC deals; credit watch system)

We support this proposal.

Credit Risk Management

Section 221(d)(4)

Debt Service Coverage:

- Deals with 95 percent rental assistance stay at 1.11
- Deals with LIHTCs increase from 1.11 to 1.15
- Market rate – increase from 1.11 to 1.20

We do not support changes to the debt service coverage ratio for any Section 221(d)(4) loans. For affordable properties, we do not understand why a distinction would be made between LIHTC properties and those with rental assistance. Further, there is a larger universe of affordable properties besides LIHTCs and those with rental assistance, such as Moderately Priced Dwelling Units (MPDUs) and other affordable units developed under density bonuses which are cross-subsidized by the market-rate units. Differentiating among all of these different types of affordable properties for purposes of setting DSC creates confusion and is not useful.

Maximum LTC remains 90 percent for projects with rental assistance, but is reduced to 87 percent for projects with LIHTCs and to 83.5 percent for market rate properties

The LTC should remain at 90 percent for all (d)(4) loans. The LTC standard is intrinsic to the FHA mortgage insurance programs. The higher leverage afforded by Section 221(d)(4) provides credit where none other exists and is an appropriate role for the government, especially in times such as these where conventional credit sources have withdrawn completely from the market. Further, if a project is limited by 90 percent of net operating income (NOI), mathematically there is already more than 10 percent equity in the deal. If a project is limited by 90 percent of cost, it already has more than 1.11 DSC. It should also

be noted that the LTC ratio does not incorporate working capital, operating deficits, and other non-mortgageable costs which are included in the private sector. Thus, the LTC of 90 percent is really closer to 80 percent. If the LTC ratio were to be reduced, then the calculation should be based on all costs to include actual costs for working capital, operating deficits, developer fee and contractor profit, not just “mortgageable” costs.

Minimum IOD of 4 months’ debt service (principal, interest and MIP)

We support this proposal as a prudent and reasonable adjustment. If this becomes the new policy, then the IOD escrow should then also be released in stages (i.e., actual use of 50 percent at completion, 75 percent at breakeven, and the balance at 12 months after Final Endorsement).

Construction contingency increased from 5-10 percent to 10-15 percent (Substantial Rehabilitation only)

The current MAP Guide requirement for the construction contingency for a substantial rehab is one to 10 percent (see Chapter 6, section 6.6 B1b (1) (f)). The amount is to be determined depending on the condition of the project, extent of rehabilitation, and experience and financial capacity of the mortgagor and contractor. Increasing the requirement to 10 to 15 percent is a significant change, especially for substantial rehabs that do not involve the alteration of the size of the dwelling or other major structural components such as the foundation, external walls, interior supporting walls, and roof framing, which is typically where unforeseen conditions surface. Sponsors are careful not to overfund the construction contingency, because unused funds cannot be spent on betterments (see Chapter 13.8d2). Further, if there are unused construction contingency funds, the mortgage is reduced by that amount, triggering the need for additional equity, which was not anticipated by the Sponsor and may be difficult to secure.

We suggest that HUD consider two classes of substantial rehabilitation – one that is applied to cases that are essentially major remodelings and one that is applied to cases that involve major structural work. Our members have found that a contingency of four to eight percent is sufficient for the substantial remodeling projects. We offer the following description of what could be considered the scope of work for substantial remodeling:

Substantial Remodeling means the renovation or alteration of a dwelling unit or building where substantially all of the interior of a building, with the exception of major building structural components, will be repaired, replaced, or upgraded. Substantial Remodeling involves improvements of a modest nature necessary to modernize the functional elements of the building, such as bathrooms and kitchens, as well as replacing equipment that is near or at the end of its useful life cycle. Substantial remodeling would also include exterior work such as the replacement of roof shingles or membranes, siding, brick repair, windows and entry doors.

Substantial Remodeling would not involve the alteration of the size of the dwelling or building or other major structural components including foundation, external walls, interior supporting walls, floor and roof framing, and staircases.

Working Capital Escrow increased from two percent to four percent to cover new construction cost overruns and change orders

The Working Capital Escrow has never been used for construction cost overruns and change orders. Changing the allowable use of these funds will only cause confusion. We suggest HUD consider a separate line item of two percent to be used for unforeseen cost overruns, change orders and/or betterments and allow these costs to be included as eligible costs in the mortgage. If the sponsor has a debt service mortgage, this will require additional equity. If it is a cost mortgage, then the additional escrow does not affect the underwriting, except the cash flow required to meet debt service coverage will be slightly higher.

No release of cash out proceeds until construction complete and sustaining occupancy achieved

We ask for clarification on this proposal. If there is an allowable cash out for land (and balance of mortgage proceeds items like working capital), this proposal would now add this cash to all the other escrows collected at initial endorsement and hold it until sustaining occupancy. Currently, a third party land seller gets all proceeds at construction loan closing. If a land seller is participating in the ownership in the deal and is therefore part of the sponsor entity, the balance of land value comes out at Final Endorsement and can go to the land seller then. Based on these assumptions as to HUD's intent, we favor retaining the current process.

Must be able to demonstrate ability to stabilize within 18 months of completion, unless waived for larger projects

We believe that this proposal will not achieve better rent up and suggest that it be redirected to address the need for the Project Sponsor to demonstrate that its management and marketing plan match or exceed the assumptions in the underwriting regarding lease-up (e.g., absorption, expenses, and milestones). We believe that a thoughtful and thorough management and marketing plan has been overlooked and that such a plan is the best tool to address HUD's concerns relative to lease-up and stabilization. We do not support the standard of a specific number of months to achieve stabilization, as that only puts pressure on the market analyst to find a way to justify that benchmark, and, further, because lease-up and absorption rates vary by project, project size and market area.

Maximum underwriting occupancy is 93 percent (decreased from 95 percent) unless waived

We support this proposed change as reasonable.

Section 223(f)

Debt Service Coverage:

- Market deals - increase from 1.176 to 1.20
- With LIHTC or rental assistance – unchanged at 1.1765

We do not support revising DSC requirements for any type of Section 223(f) transaction since this is an intrinsic element of the program.

Sustaining occupancy will be defined as 90 percent physical occupancy and 85 percent economic occupancy for six months prior to application; maximum underwriting occupancy is 93 percent.

First, we believe that any such requirement should only be for three months.

The pre-application requirement for sustaining occupancy at 90 percent physical occupancy and 85 percent economic occupancy for any period of time (in any case no more than three months , not six months) should only apply to loans requesting mortgage insurance under the waiver of the three-year rule.

We believe the current standard of 95 percent maximum underwriting occupancy standard should be retained. Affordable housing deals which avail themselves of Section 223(f) have historically had occupancy levels far higher than 95 percent. This is especially true for affordable housing deals which are coming off regulation and have the benefit of both project-based Section 8 and Enhanced Vouchers to keep occupancy levels comfortably above 95 percent. As for market rate deals, underwriting at 93 percent in strong markets is unnecessary and could result in a reduction of both net operating income and value.

Audited financials for previous year must be provided for properties of 50+ units, but can be waived for acquisition financings only

Most owners do not have audited financial statements. This requirement would seriously impede the program by making many deals ineligible. We do not support this proposal.

Clear all accounts payable, project liability and deferred management fees at closing

This requirement needs clarification. Is HUD concerned about clearing liabilities to assure sufficient cash to pay debt service? We suggest a better alternative might be to request the sponsor to provide a plan on how liabilities will be liquidated.

Maximum 75 percent LTV if cash out; release of cash out deferred until repairs are completed

We believe that the existing requirement for 80 percent cash out is reasonable. To do otherwise is to punish owners who have maintained low or no leverage in their properties. We do not understand the basis of this proposed change. Are 80 percent cash outs defaulting?

Failed condos where some condos were sold may not be eligible for HUD financing

This is unclear. We are not aware of instances where a failed condo with sold units could be eligible for HUD financing.

Processing

We generally support most of HUD's proposals for changes related to the processing of FHA multifamily loans, with the few exceptions as noted. However, we would like to emphasize the importance of reducing processing times.

Expedited processing for applications that help FHA meet its housing goals (more clarity will be provided on this once HUD's strategic plan is published) and those applications which are easier to process (no definition of this yet)

We cannot support such a broad new policy without further details from HUD and additional opportunities to comment on any proposed changes. Any major change in how HUD distributes its resources, e.g., exclusion of market rate properties or queuing of loans based on to-be-determined criteria rather than first-come, first-served, requires a major industry discussion.

Greater scrutiny of new applications in submarkets where there is existing concentration of insured portfolio or with recently completed 221(d)(4)s in stabilization

We support this approach.

For areas with high vacancy rates and high concentrations of HUD insured mortgages, field office has to review how other HUD-insured transactions in the area are performing as part of pre-app review process.

We support this approach.

All applications eligible to be submitted under MAP must be submitted under MAP, not TAP

We support this approach, but we would like to see HUD bring Sections 223(a)(7) and 241 under MAP.

Mortgagees will be encouraged to sit down early with the field offices to prescreen applications before they are submitted

We support this proposal.

Underwriting narrative will be standardized (similar to LEAN)

We support this proposal.

Mortgagee and borrower certifications will be combined (similar to LEAN)

We support this proposal.

Applications and third party reports must be submitted in hard copy as well as via disc or flash drive.

We support this proposal.

Section 223(a)(7)s may be allowed to be processed under MAP, and OAHF may have a role in the processing where preservation is involved.

We support this proposal.

Under TAP, the borrower will be given the option of paying for third-party reports to expedite the processing

This is acceptable.

Implementation

We believe that HUD, in implementing any proposed changes, needs to be cognizant of the immediate and future impact on project sponsors. It should be emphasized that, for those sponsors who have loans in the pipeline, considerable time and financial resources have already been expended. Sponsors in such situations need time to complete the application and approval process.

Regarding 221(d)(4) processing, we recommend:

Implementation on January 1, 2011, or at least eight months from official publication of a Mortgagee Letter of the changes. This will provide sufficient time to move loans through the pipeline. If a sponsor has received an Invitation Letter and submitted the application for firm, and HUD has cashed the check, the loan should be underwritten on the current underwriting requirements.

After January 1, 2011, or eight months from the publication of the Mortgagee Letter, sponsors would use the new requirements for an application for firm no matter when the Invitation Letter was approved. That gives the sponsors the responsibility to determine whether to take the risk now to start the application/development process.

Regarding 223(f) processing, we recommend:

Section 223(f) processing could have a shorter transition period from publication of the Mortgagee Letter to implementation, say four to six months. That would give sponsors who have deals in the pipeline time to wrap them up and get them submitted whether they were for refinancing or acquisition.

As above, if a sponsor has received an Invitation Letter and submitted the application for firm, and HUD has cashed the check, the loan should be underwritten on the current underwriting requirements.

Submitted by:

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