NMHC National Multi Housing Council®
Apartments: Smart Communities, Smarter Living

National Apartment Association

April 5, 2012

Deputy Assistant Secretary Marie Head
Multifamily Housing Programs
Office of Multifamily Housing Programs
U.S. Department of Housing and Urban Development
451 7th Street, SW, Room 6106
Washington, DC 20401

RE: Comments on Multifamily Housing Notice H 2011-36
"Large Loan Risk Mitigation Policies"

Dear Deputy Assistant Secretary Head:

The National Multi Housing Council (NMHC) and the National Apartment Association (NAA) wish to provide our input to Large Loan Risk Mitigation Policies guidance (Multifamily Housing Notice H 2011-36) issued on December 29, 2011. As we discussed in our meeting on March 5, 2012, and with Secretary Donovan on March 14, 2012, the apartment industry appreciates the opportunity to maintain a dialogue with the Department of Housing and Urban Development (HUD) over program changes, guidance and processing activities. We support a more transparent and collaborative approach between the Department and industry stakeholders.

We welcome the Federal Housing Administration's (FHA's) efforts to respond to the increased demand for multifamily loans through new processing and application review activities. We further appreciate the increased program performance information and transparency, as well as response to inquiries we have made regarding transaction approvals, particularly given processing issues associated with guidance and policy changes.

Despite these positive steps, we regret that the Department declined to engage the apartment industry in drafting the Large Loan Risk Mitigation Notice. The Department never sought input during the development of the notice, and we only learned that staff was working on this guidance at the conclusion of a meeting on a separate topic with lender and apartment industry stakeholders on October 5, 2011. At that meeting, multifamily program staff notified stakeholders about their intent to develop a separate credit policy for large loans. The staff did not provide us with a timetable for issuance of the notice or that FHA intended to issue the guidance in a unilateral manner. We understand this was a time of transition in leadership at the Office of Multifamily Housing and believe it was an oversight. Nonetheless, it is important that we provide this reference in framing our comments.

General Comments

To frame the industry's input, the Department must consider our view of the FHA multifamily program, and in particular the Section 221(d)(4) loan program for new construction. The purpose of the FHA multifamily insurance programs for new construction, substantial rehabilitation, in particular the Section 221(d)(4) program and the 223(f) refinancing programs are designed to ensure a consistent supply of

1850 M Street, NW, Suite 540 ▪ Washington, DC 20036 ▪ 202.974.2300 ▪ FAX 202.775.0112 ▪ www.nmhc.org ▪ info@nmhc.org

liquidity to the multifamily market. This commitment is critical to build and finance rental housing for America's workforce regardless of the condition of the private capital markets. By adopting special discriminatory rules making HUD's financing of larger projects unattractive, HUD is once again fostering an anti-urban public policy. Suburban and rural projects are generally smaller and less expensive to build than more complicated urban projects. Land in cities is more expensive and difficult to secure. The entitlement process is often more complicated and requires added investment. High-density construction, regardless of building material used, is more expensive than low-density construction. Therefore, in promulgating policies that make the FHA financing programs more expensive and less attractive, if not completely unattractive, for large projects, HUD is again adopting an anti-city policy.

We respect that FHA is working to improve management of credit risk of the multifamily insurance program. We agree that this is part of FHA's fiduciary responsibility. We support a sound approach to manage credit risk and believe that consistent and reliable policy benefits apartment developers and owners. We also understand that current economic conditions have placed increased pressure on FHA to review credit policy for both single-family and multifamily mortgage insurance programs. Recent changes to the multifamily program's terms and requirements, approval process, documentation (MAP Guide) and closing documents represent HUD's best effort to set a positive future course for the program.

The Notice to mitigate risk on large loans tightens lending requirements and mandates greater levels of investment by developers to limit the government's exposure. However, the Notice does not:

- reduce the government's requirements that developers pay higher cost for labor and wages;
- expedite the processing to reduce the cost and provide greater certainty to approvals;
- lower fees and costs to make the program more competitive with the private market;
- increase per-unit loan limits to support soring development costs and the price of land in in-fill markets, or
- promote or maintain reasonable borrower recourse requirements to make the program more competitive.

In fact, the Notice's policy works to the detriment of the industry and to the government's goal of promoting the development of quality, affordable rental housing in urban locations that supports transit oriented areas. We are concerned that FHA does not wish to provide insurance for large loans, that FHA is placing unnecessary restrictions on who can participate in the program as opposed to underwriting the loan application and making a prudent credit decision. We do not find this to be an appropriate public policy, especially at a time of constrained rental housing supply and continued liquidity issues in the market.

The Notice provides background regarding HUD's concern and exposure to large loans, noting, *"The insurance fund can suffer an extraordinary loss form the failure of a large loan since it represents such a concentrated investment in a single large property located in a single submarket with one borrower and potentially hundreds of rental units."* This may be true, but this is not due to the size of the loan but, rather, a result of poor decision-making in the underwriting process or factors external to the loan. NMHC/NAA recommends that FHA focus on the underwriting of individual loans instead of modifying loan requirements. The Department should be encouraging larger loans and as a matter of public policy look to take risk to improve neighborhoods, develop energy efficient and sustainable projects, take advantage of transit-oriented locations and fund projects that will offer greater local employment opportunities through retail trade and services while simultaneously creating hundreds of construction jobs.

The government's path to get to this policy also troubles us. There is limited evidence that FHA has been overrun with large new construction loan applications. The data in Table 1 indicates that FHA's exposure to large loans is not systemic and manageable. In fact, it appears that large loans make a significant contribution to the program's insurance fund to reduce overall program default risk. While it is true that construction loans comprise over a quarter of large loan applications, the number of large multifamily loans processed by FHA is less than three percent of all conventional loans. Moreover, large multifamily loans represent less than one percent of all conventional multifamily mortgage loan applications received by FHA, both new construction and refinance. The point of presenting this data is to suggest that FHA may more appropriately manage credit risk by focusing attention on the approval and underwriting process.

Table 1
FHA Conventional Multifamily Insured Large Loan Activity FY 2011

Loan Type	#Loans	Loan Volume UPB	Annual MIP
Large Construction Loans as % of Total Construction Loans	7.4%	28.0%	28.0%
Large Loans as % of Total Section 223(f) Program	0.7%	5.8%	5.8%
All Large Loans as % of Total New Construction and 223(f)s	2.7%	16.1%	16.1%

Source: FHA and Mortgage Bankers Association Analysis

There is no indication that FHA has suffered material losses due to insuring loans on large multifamily projects. In fact, our members who have secured a large FHA insured loan indicate that these loans, on average, have lower leverage and are typically higher quality (i.e., in terms of age, construction and property amenities) than typical a typical loan in FHA's portfolio.

Specific Comments:

1. Debt Service and Loan-to-Cost or Loan-to-Value

   NMHC/NAA strongly oppose setting separate loan terms and requirements based on loan amounts, especially for new construction loans under Section 221(d)(4). FHA shares the exposure and risk concerns with developers and borrowers, as the sponsors investment and cash outlays rize along with the size of a project. Therefore, there is greater incentive for the borrower and principals to meet the program terms and conditions, complete the construction on time and stabilize the property. Large construction loans typically involve more complicated construction requirements, (mid-rise, extensive site improvements, mixed-use components, significant energy and sustainability components, etc.), so the developer typically has much greater investment and exposure in development, planning and site preparation costs at the time of and during the FHA application process.

Additionally, FHA should evaluate the barriers to successful development projects such as land, entitlement, site management and the cost of labor and materials in high-cost markets. Most to the projects are urban and in-fill locations. Other lenders do not have the same program barriers that FHA has, including per-unit loan limits, Davis-Bacon wage restrictions, and documentation requirements. Further, other capital sources are much more effective in executing the commitment and negotiating the terms of the transaction based on the specific needs of the development project. As such, we would recommend that, at a minimum, FHA consider application of more favorable loan terms for high-cost areas and high-barrier-to-entry locations.

Making policy changes based on risk and credit analysis of private credit providers is not applicable due to the product differences of self-amortizing and balloon mortgages, especially for refinancing Section 223(f) mortgage debt. FHA does not underwrite refinance risk, as the loans are self-liquidating, long-term amortizing loans. As such, FHA has appropriately focused underwriting on debt service coverage and appropriate reserves for maintenance and capital repairs. Additionally, FHA mortgage insurance does not permit subordinate loans, partnership mezzanine or second lien debt or equity takeout loans on a property.

Reducing the loan amount would be more prudent with a balloon mortgage or shorter amortization to address refinance risk. This is not the case with the FHA product. Loan size does not reduce the government's risk for larger loans as much as making loans to weaker sponsors with less capacity. FHA should seek project sponsors that have greater capacity to develop and operate properties. We feel that to attract quality sponsors, that FHA should provide both a product and process application in a manner that will attract qualified sponsors.

2. Initial Operating Reserves

The proposed increases in the investment of initial operating deposits (IODs) and the debt service reserves are excessive and punitive. They greatly increase the applicant's equity investment beyond the commensurate risk. Analysis of existing applications using the proposed IOD percentages and debt service reserves would triple the set-aside of capital during the property lease-up and stabilization period. Having consulted with FHA lenders we support the grid in Table 2 to calculate the term of the scope of the debt service reserve during lease-up and stabilization and the IOD amount for Section 220, 221(d)(3), 221(d)(4) and Section 231 transactions.

Table 2
IOD Reserve Grid by Loan Amount

Loan Amount	Debt service reserve	IOD as % of Loan Amount
< $25 M	4-6 months	3.0
$25-40 M	4-6 months	3.0
Over $40 M	12 months	4.5

There is limited reason for extending the operating deposit beyond one year. The IOD release should be based on property performance, which we believe is represented by 6 consecutive months of break-even occupancy. Furthermore, we suggest the release of the debt service reserve should be the later of 12 months from substantial completion (6 months for substantial rehabilitation projects) or six months of break-even debt service coverage (DSC) to breakeven or (1.0x DSC). We recommend that the same release provisions be applied to the working capital escrow.

3. Other Requirements

   a. Borrower Principal Net Worth and Liquidity

      We generally support the concepts for measurement of strong sponsors based on principal net worth and liquidity. We recommend that FHA apply the specific requirements in context with other key factors, including, the actual sponsor's equity in the land and buildings, pre-development costs, overall loan-to-cost for a new construction loan and loan-to-value in the case of a refinance loan. We also recommend that FHA give greater consideration of the operating experience of the borrowing entity in both refinance and new construction applications. Much of the risk to FHA/Ginnie Mae is associated with the effective lease-up and operation of the asset as opposed to borrower equity.

      The underwriting and mortgage credit requirements for large loans apply the requirement of the principals of the borrowing entity "in aggregate." This rightly provides principals the ability to meet the requirement utilizing both a General Partner and Limited Partners (Managing Member and Members in LLCs). HUD internal email guidance provided to lenders in January 2012 regarding the individuals and entities that are required to sign the exculpation provisions in the Note as described in Paragraph 50 of the regulatory agreement non-recourse carveouts (Paragraph 50) stated that the individual signing must also meet these requirements.

      Because the General Partner (the individual/entity who is typically required to take these responsibilities) may not be able to meet the 20% net worth and 7.5% liquidity requirement, NMHC/NAA are concerned that many experienced borrowers with strong properties under their ownership will effectively be unable to participate in the FHA multifamily insurance program. Limited partners often provide significant equity in a transaction, but they are passive investors and require their liabilities to be limited. As such, they will not execute non-recourse carve-outs. This creates a practical problem relative to the requirement for the signatory for Paragraph 50 of the regulatory agreement to have both 20% net worth and 7.5% liquidity. We strongly request HUD revisit the recourse provisions and recommend that the liquidity requirements be set at 5 percent of the loan amount for large loans.

   b. Delayed release of cash out loans

      The Department did not provide a rationale related to the additional risk factors requiring changes from policy regarding cash out provisions. Other than the size of the loan, the requirements in the MAP Guide (Sections 8.13 J: "Cash-Out from Land Equity" and 8.13 K: "Cash---Out/Equity from Loan Proceeds") are adequate to protect FHA's interest.

Conclusion:

FHA should be a consistent source of construction/permanent financing that is competitive and complements other debt capital in the market. There are program requirements, processing issues and costs with FHA's multifamily loan programs that exceed those applicable from their private sector counterparts and are a disadvantage to the developer. Therefore, this and other recent policy shifts have not reduced credit risk. However, they have acted to reduce the incentives for quality and credit worthy developers and borrowers to use the program.

We are concerned with the direction FHA has gone with the Large Loan Risk Mitigation Policy Notice H 2011-36. We welcome your consideration of our comments and are available to discuss these and any other aspects of the effort to mitigate risk for large loans.

Please contact David Cardwell, NMHC Vice President of Capital Markets, at (202) 974-2336 or by email at dcardwell@nmhc.org should you wish to discuss further.

Sincerely yours,

Douglas M. Bibby
President
National Multi Housing Council

Douglas S. Culkin, CAE
President
National Apartment Association