

U.S. Department of Housing and Urban Development

Special Attention of
All Multifamily Hub Directors
All Program Center Directors
All Project Managers
All Field Office Directors

Notice H 2010-11

Issued: July 6, 2010

Expires: July 31, 2011

Cross References
Mortgagee Letter 2010-21

SUBJECT:
HUD Multifamily Risk Mitigation

I. Purpose

This Housing Notice revises underwriting standards, policies and procedures for mortgage insurance under the Federal Housing Administration's (FHA's) Multifamily Housing programs. This Housing Notice is not applicable to the health care programs administered by the Office of Healthcare Programs (Section 232, or refinancing of Section 232 pursuant to Sections 223 (f) or 223 (a) (7)). The Notice will be effective 60 days from the date of issuance, as discussed below in the section titled "Implementation".

The core program underwriting standards have not been adjusted since the inception of the program and it is appropriate to do so at this time. These changes are in response to changes in real estate and financing markets and are intended to mitigate the Department's risk while ensuring the continued availability of FHA insurance.

II. Background

On January 6, 2010, the Federal Financial Institutions Examination Council (FFIEC) issued an Advisory to remind institutions of supervisory expectations regarding sound practices for managing risk. The FFIEC noted the challenging financial environment and stated,

“Current financial market and economic conditions present significant risk management challenges to institutions of all sizes. For a number of institutions, increased loan losses and sharp declines in the values of some securities portfolios are placing downward pressure on capital and earnings.”

This cautionary note is consistent with increases in vacancy and delinquency rates and increases in defaults and claims in FHA's portfolio. Interest in FHA insurance has dramatically increased as other sources of commercial financing have not been available. FHA is committed to playing a critical role in restoring health to the multifamily housing market by assisting qualified Borrowers to access mortgage financing when private capital is scarce. With this increased role comes increased risk and responsibility for the integrity of the FHA mortgage insurance fund.

Separately, HUD is also revising Lender capitalization, licensing and monitoring requirements, updating legal documents, and modernizing HUD's information systems and business processes. This Notice supplements those efforts by updating underwriting requirements to better reflect industry standards and best practices.

III. Risk Mitigation Measures

A. General

1. Definition of Affordable Housing.

- a. For purposes of applying the affordable housing underwriting standards and program requirements, as set forth below, "affordable" is defined as: (a) projects that have a recorded regulatory agreement in effect for at least 15 years after final endorsement, (b) projects that meet at least the minimum Low Income Housing Tax Credit (LIHTC) restrictions of 20% of units at 50% of the Area Median Income (AMI), or 40% of units at 60% of AMI, with economic rents (i.e. the portion paid by the tenants) on those units no greater than rents on those units no greater than LIHTC rents, and (c) mixed income projects if the minimum low income unit rent and occupancy restrictions and regulatory agreement meet the above criteria.
- b. Projects need not use LIHTCs to qualify for affordable underwriting so long as they have, and are in compliance with, a recorded regulatory agreement imposing the minimum low income occupancy and restricted rent tests in (a), above, and having a term of at least 15 years after final endorsement.

2. Applicability of Underwriting Changes.

Except where specified in this Housing Notice, the revised Section 221(d)(4) underwriting standards, reserve and processing requirements are applicable to transactions processed under the Section 220, 221(d)(3), 231 and 241(a) programs. This guidance does not supersede requirements for those programs on matters not addressed in this Housing Notice.

The underwriting standards for projects that have project based rental assistance will apply for projects that meet the definition of Affordable Housing above, but also have project based rental assistance for greater than 90% of the units.

3. Changes in Debt Service Coverage Ratios and Loan Ratios.

Loan amounts are the lesser of: a) the requested mortgage amount, b) the amount allowed by statutory limits, c) the amount supportable by debt service, or d) the amount supportable by the applicable loan ratio. The current and new debt service coverage ratios (DSCR) and loan ratios (LR) are listed in the tables below.

Changes to Debt Service Coverage Ratio (HUD 92264-A, Criterion 5)				
Section of the Act	<u>Current</u> DSCR	<u>New</u> DSCR	<u>Current</u> Criterion 5 LR	<u>New</u> Criterion 5 LR
221(d)(3) and 221(d)(4) with 90% or greater rental assistance- no change	1.11	1.11	90.0%	90.0%
221(d)(4): affordable	1.11	1.15	90.0%	87.0%
221(d)(4): market rate	1.11	1.20	90.0%	83.3%
221(d)(3) affordable transactions	1.05	1.11	95.0%	90.0%
223(f) refinance of a Section 202 property	1.11	1.11	90.0%	90.0%
223(f) with 90% or greater rental assistance	1.176	1.15	85.0%	87.0%
223(f) affordable	1.176	1.176	85.0%	85.0%
223(f) market rate refinance or acquisition	1.176	1.20	85.0%	83.3%

Note: The Debt Service Coverage Ratios have been rounded to two or three decimal places for presentation purposes.

Changes to Value / Cost Loan Ratios				
Section of the Act	<u>Current</u> Criterion 3 LR	<u>New</u> Criterion 3 LR	<u>Current</u> Criterion 7 LR	<u>New</u> Criterion 7 LR
221(d)(3) and 221(d)(4) with 90% or greater rental assistance	90.0%	90.0%	N/A	N/A
221(d)(4): affordable	90.0%	87.0%	N/A	N/A
221(d)(4): market rate	90.0%	83.3%	N/A	N/A
221(d)(3) affordable transactions	100.0%	95.0%	N/A	N/A
223(f) refinance of a Section 202 property	90.0%	90.0%	N/A	N/A
223(f) with 90% or greater rental assistance	85.0%	87.0%	85%	87%
223(f) affordable	85.0%	85.0%	85.0%	85.0%
223(f) market rate refinance	85.0%	83.3%	N/A	N/A

223(f) market rate acquisition	85.0%	83.3%	85%	83.3%
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There is no change to the current criterion 10 loan ratio for cash out refinancing.

Section 220 projects underwritten to the maximum commercial space or commercial income allowed by the program must be underwritten to market rate standards even if all or some of the housing units are affordable. Section 220 projects with both commercial space and commercial income less than the maximum allowed in the program can be treated as affordable so long as they meet the definition in Section III.A.1 above.

4. Mortgage Credit Analysis and Terrorism Check of Principals

- a. Existing published guidance, for example Handbook 4470.1 Chapters 1 & 3, and Handbook 4565.1 Chapter 6 paragraph 6-9, provide requirements of balance sheets and supporting schedules for the single asset entity mortgagor, plus its principals. Principals in this context are defined as those parties subject to Previous Participation Active Partners Performance System (APPS/2530) review, see 24 CFR 200.215.
- b. Mortgage credit review of a Limited Liability Company (LLC) follows a similar equity and control standard for principals in a Limited Partnership. Managing Members (analogous to a General Partner) and Members with an aggregate interest of 25 percent or greater are subject to mortgage credit review.
- c. Given the increased possibility for principals to be in material adverse financial positions as potentially over-leveraged short term debt comes due in the next several years, the Lender’s credit review is particularly important. Generally, the Lender and HUD have exercised discretion in the extent of mortgage credit review where the single asset mortgagor entity is fully funded. Because of concerns about the impact of volatile real estate fundamentals, and the lack of liquidity in the commercial real estate financing markets, this Housing Notice is emphasizing the need for mortgage credit review by the Lender on all principals and affiliates, whether or not the single asset mortgagor entity is fully funded. The Lender’s mortgage credit review must include:

The balance sheets for all principals should, in addition to other relevant schedules, contain a Schedule of Real Estate Owned, and a Schedule of Mortgage Debt. Sample templates of these schedules are attached.

The Lender’s mortgage credit review and Firm Commitment submission should address the creditworthiness of all principals, and contain a written analysis of the financial position and contingent liabilities, particularly all mortgage debt with near or intermediate term balloon payments (i.e. within the next 5 years).

The Lender’s analysis of the various properties’ net operating income, outstanding indebtedness, valuation estimates etc., with details supporting the Lender’s assessment of the likelihood of successfully refinancing projects with maturing balloon debt, assuming current capital markets conditions and the current availability of alternative long term financing sources.

The Lender's analysis should reconcile the data, and come to a conclusion as to the principals' creditworthiness. Particular attention should be given to principals with a history or anticipated incidence of adverse credit actions including (but not limited to) bankruptcies, foreclosures, or a pattern of renegotiating debt.

A financing plan for any shortfall or anticipated lack of available credit should be provided. Both conventional financing and other FHA insured loans should be included in this analysis.

- d. The US Patriot Act requires Office of Foreign Assets Control (OFAC)/Terrorism checks and verifications on principals. These checks must be completed and documented prior to Initial Endorsement, whether or not the Lender is a regulated financial institution. OFAC requirements are administered by the Department of the Treasury, and Lenders should refer to Treasury's website, <http://www.ustreas.gov/offices/enforcement/ofac>, if they have questions.

5. Concentration of Principal Risk.

Particular attention and additional scrutiny will be given in cases where principals have greater than \$250,000,000 of outstanding FHA insured debt. Based on their review of the principals' Schedule of Real Estate Owned, the lenders must identify principals that exceed this \$250,000,000 threshold. Lenders will need HUD pre-approval before such principals or Borrowers may apply for additional insurance commitments; further guidance will be issued separately to address the process for obtaining HUD approval.

B. Program Changes – Section 223(f) Program Underwriting Guidelines

1. Occupancy Standards

Projects must have an average physical occupancy rate of at least 85%. For market rate properties, the maximum underwritten physical occupancy rate is 93%. For affordable properties, the maximum underwritten physical occupancy is 95% if a property has: a) at least 90% of units covered by a rental assistance contract, or b) affordable rent restrictions on 100% of units with all unit rents at least 20% below comparable market rents.

Projects must demonstrate a pattern of stable physical occupancy, i.e. the average occupancy standards noted above, for a period of six months prior to submission of the Firm Commitment application, and maintain that occupancy through to the date of Initial/Final Endorsement. Continued occupancy consistent with the underwriting conclusions must be documented with an updated rent roll no more than 30 days prior to closing. The following special condition will be added to Firm Commitments:

The Borrower must submit an updated, certified rent roll detailing the occupancy level at the project. The rent roll must be dated no more than 30 days prior to endorsement. If HUD determines that the updated rent roll shows a significant change in occupancy from that submitted at the time of

application and that was assumed in the loan approval, then this Commitment shall be of no force or effect and will be cancelled by HUD.

The occupancy provision described above applies to all Section 223(f) applications, with the exception of those applying for a 3-year rule waiver. The provisions for sustaining occupancy requirements issued in previous guidance are superseded by this Notice as follows:

Occupancy standards for refinancing under the 3-year rule waiver, including for qualifying condominium buildings that operate as a rental project, are as follows: a) meet the minimum sustaining occupancy requirements for 3 months prior to endorsement, and b) fund a debt service reserve of 4 months principal, interest and Mortgage Insurance Premium (MIP), which will be released once the property has maintained break-even occupancy for 6 consecutive months after Initial/Final endorsement. HUD Mortgage Credit staff will consult with Asset Management staff prior to approving the release. 3-year rule waiver properties that have sustained an average minimum 85% physical occupancy for 6 months prior to application submission and maintain it during application processing, with confirmation by a rent roll submitted within 30 days of endorsement, will not be required to fund a debt service reserve.

2. Market Study

Section 223(f) proposals typically do not require a market study separate from that contained in the appraisal, however in volatile or declining markets, the Lender should consider and may be required to obtain such a study to support the underwriting conclusions of market demand for the subject property over the loan term. Multifamily Program Center staff should consult with Economic Market Analysis Division (EMAD) in such cases.

3. Release of Cash / Equity from Loan Proceeds

The loan to value ratio (in criterion 10 of the HUD 92264-A) for cash out refinances remains unchanged at 80%. Fifty per cent (50%) of any cash out proceeds after funding transaction costs, including the assurance of completion requirements, must be held in escrow by the Mortgagee until the required non-critical repairs are completed and HUD approves the release.

4. Financial Statement's for Underwriting Section 223(f) Refinancing and Acquisition Projects.

To confirm the accuracy of the property financials, the Borrower must provide three years of tax returns for the project or borrowing entity. In addition, the Borrower must provide a property financial statement that is reviewed by an independent third party Certified Public Accountant (CPA) and includes actual copies of the insurance and property tax bills. The

Multifamily Hub Director may grant a waiver of this requirement for acquisitions. The CPA review is applicable to the most recent full year financial statement and Borrower certifications are acceptable for the required previous years' statements.

5. Past Due Payables and Project Liabilities.

Past due accounts payable and outstanding liabilities for project operating expenses must be cleared and released, or otherwise fully satisfied, prior to or at loan closing. Examples of such items include deferred management fees, over-due utility bills or real estate taxes, or trade payables. These items are not to be included in the eligible debt basis in the calculation of the cost to refinance. If the transaction does not involve a Transfer of Physical Assets, and if approved by the Multifamily Hub Director, surplus cash notes may be established for payables owed to a related entity only.

6. Underwriter Site Inspection and Rental Lease Audit Requirement

The Multifamily Accelerated Processing (MAP) approved underwriter must perform an on-site lease audit and physical inspection representing a sample of each unit type. An analyst, underwriter trainee, or MAP approved underwriter acting under the direction of the underwriter (i.e., one that does not report to the originator) may perform the site visit and physical inspection of the units.

For projects 50 units or less: Inspect at least one of each unit type, to include a representative sample of 10% of the units.

For projects between 51 and 250 units: Inspect at least one of each unit type, to include a representative sample of 10 units plus 5% of the total number of units greater than 50.

For projects greater than 250 units: Inspect at least one of each unit type, to include a representative sample of 15 units, plus 2% of the total number of units greater than 250, for a maximum of 50 units.

The Lender must compare the terms of the lease agreements to the rent roll, verifying the unit number, tenant name, lease commencement date, expiration date, concessions if any, and monthly rent, and confirm that this data is consistent with the assumptions used in the underwriting analysis.

7. Reserve for Replacement

The minimum reserve for replacement deposit is \$250 per unit per year or such higher amount as is indicated by the Property Capital Needs Assessment (PCNA), even with an initial deposit to the reserve for replacement escrow. Projects must obtain a new PCNA every 10 years, with the reserve for replacement deposit adjusted based on the results of the PCNA. HUD Asset Management staff must review and concur or non-concur on the deposit requirements. Development staff will consider this determination and make a final determination of the reserve requirements. The reserve schedule and deposit requirements

required by the Firm Commitment will be applicable during the first ten year term of the mortgage.

8. Condominium Ownership Regimes

A project which was built and intended as condominiums, but is now operating or proposed to operate as a rental project, may be considered under Section 223(f) if the condominium regime is converted to a single owner with no individual unit ownership, and the property meets the other program guidelines, including the minimum occupancy standards.

Condominium ownership regimes and plots may be recorded if the property is otherwise operated as a rental project with a single ownership entity owning all the apartments. Separate condominium units may be established for commercial use and for housing use which must include all the residential apartments. The FHA insured loan must be secured by a mortgage on the rental apartment portion and any mortgageable commercial space. Joint use and maintenance agreements and easements between the FHA insured portion of the property and any separately demised condominium portion must be defined.

The Multifamily Hub Director may consider a waiver for a condominiumized building with a limited number of individually owned units if all the owned units are located in a separate building or in a separate section of a single building apart from the rental units. HUD will not consider a waiver if any ownership units are interspersed with the rental units.

C. Program Changes - Section 223(a) (7) Refinancing

1. Eligibility for MAP Processing

Section 223(a) (7) refinancing transactions (except those subject to the Memorandum of Understanding with the Office of Affordable Housing Preservation) may be processed under MAP and will be subject to the MAP processing time frames for 223(f) Firm Commitments.

2. Past Due Payables and Project Liabilities

Past due accounts payable and outstanding liabilities for project operating expenses must be cleared and released, or otherwise fully satisfied, prior to or at loan closing. Examples of such items include deferred management fees, over-due utility bills or real estate taxes, or trade payables. These items are not to be included in the eligible debt basis in the calculation of the cost to refinance. If not subject to a transfer of physical assets (TPA) and approved by the Multifamily Hub Director, surplus cash notes may be established for payables owed to a related entity only.

3. Reserve for Replacement and PCNA Requirement

A PCNA is required with submission of the application. The minimum reserve for replacement deposit is \$250 per unit per year or such higher amount as is indicated by the

PCNA, even with an initial deposit to the reserve for replacement escrow. Projects must obtain a new PCNA every 10 years, with the reserve for replacement deposit adjusted based on the results of the PCNA. HUD Asset Management staff must review and concur or non-concur on the deposit requirements. Development staff will consider this determination and make a final determination of the reserve requirements. The reserve schedule and deposit requirements required by the Firm Commitment will be applicable during the first ten year term of the mortgage.

D. Program Changes - New Construction and Substantial Rehabilitation Program Underwriting Guidelines

The new construction and substantial rehabilitation multifamily programs affected by this Housing Notice are the Section 220, 221(d)(3), 221(d)(4), 231 and 241(a) programs.

1. Application Fees

FHA Application Fees remain \$3 per \$1,000 (30 basis points) of the mortgage amount. Market rate pre-applications must pay a non-refundable 15 basis point review fee, which fee will be credited to the 30 basis point Firm Commitment fee if an invitation letter is issued and a Firm Commitment application is submitted. Affordable housing transactions (as defined in Section III.A.1) that submit for two stage processing must pay the 30 basis point fee at the Firm Commitment stage, but will not be charged a fee for pre-application review.

2. Pre-Application Exhibits

The pre-application exhibits as described in existing guidance must include:

- a) Preliminary appraisal work which includes a narrative rental and expense analysis with the submission of forms HUD 92274, 92273 and the 92264-T, if applicable and an estimate of land value for new construction projects (or “as is” value for substantial rehabilitation project) by comparable analysis. The complete appraisal with a cost approach may be submitted with the application for Firm Commitment.
- b) The lender’s assessment and preliminary evaluation of the sponsor’s creditworthiness. To the extent the mortgagor entity and principals have been identified at this stage, initial information about the sponsor’s experience, including a brief summary of mortgage credit qualifications and schedule of real estate owned and maturing debt should be provided with the pre-application.

3. Market Studies

For all new construction and substantial rehabilitation projects with significant tenant displacement, the appraisal and market study should be completed by different firms. This requirement includes LIHTC transactions with economic rents, which do not have project based rental assistance. The Hub Director can waive this requirement on a case-by-case basis, if it is clear the appraiser or appraisal firm is capable of performing both the appraisal

analysis and a macro-economic market analysis, and if the strength of the market is not in question.

4. Underwritten Occupancy

Underwritten physical occupancy is limited to 93% for market rate properties. If a property has: a) at least 90% of units covered by a rental assistance contract, or b) affordable rent restrictions on 100% of units with all unit rents at least 20% below comparable market rents, the maximum underwritten physical occupancy is 95%.

5. Number of Units

Generally, HUD has allowed absorption periods up to 24 months. Due to volatility and weakness in the real estate markets, the absorption period used in estimating market demand for the proposed number of units will now be restricted to 18 months. Larger projects may phase additional units under a separate application for mortgage insurance (e.g. under Section 241(a).) An exception to the 18 month limitation on the absorption period may be considered by the Multifamily Hub Director for large high rise buildings. Such projects will be evaluated based on their own merit and may require a larger initial operating reserve to insure against slower than anticipated absorption.

6. Marketing, Leasing, and (if applicable) Relocation Plan

All projects which require absorption of units at economic rents to achieve break-even occupancy must submit a detailed marketing and leasing plan and budget that has been reviewed and confirmed by the proposed property management company. The plan must discuss when marketing efforts will begin, when the leasing office and model units will be opened, how the leasing office will be staffed, and the project's marketing and advertising strategy. The plan must address timing of the construction progress schedule with respect to egress and ingress into the project, landscaping, and access to amenities. These items are in addition to those required by the Affirmative Fair Housing Marketing Plan.

For substantial rehabilitation projects involving temporary relocation or displacement of tenants, the plan must address details of timing, funding and management of the relocation process.

7. Cash Out from Land Equity

If land, or "as is" value for a substantial rehabilitation project, is contributed to meet the sponsor's equity requirement, any cash out from the land equity above what is required at initial endorsement must be deferred until the project is complete and it has demonstrated to the HUD field office's satisfaction that the project has achieved 6 months of break-even occupancy. This does not prevent applying land value equity to fund operating deficit or working capital escrows, or other cash requirements at initial endorsement.

8. Construction Contract Retainage

Currently, a holdback of 10% of the construction contract amount is retained for each construction advance. This notice revises the requirements for construction retainage if:

- a) The Contractor has no identity-of-interest with the owner greater than a 5 percent equity interest,
- b) If applicable, prior written consent from the surety company must be attached to the request for release, and
- c) There are no questions regarding the contractor's performance concerning the quality of work, compliance with the contract and any change orders or work in progress.

Assuming these conditions are met, the existing standard of 10% retainage will be required until 50% completion. After that, the requirement will be 5% retainage until 75% completion and 2.5% retainage until the loan reaches final endorsement.

9. Contingency Escrow Requirements for Substantial Rehabilitation.

Construction contingency requirements for all substantial rehabilitation projects are increased to 10-15% of construction cost. The Borrower may elect to apply any funds remaining in the substantial rehabilitation construction contingency account after completion of the approved rehabilitation, to: a) further improvements, betterments or upgrades to the property, or b) reducing the mortgage balance. If excess funds from contingency are used for betterments, those additional improvements will not be considered as the basis for a request for an increased mortgage amount.

10. Furniture, Fixture and Equipment (FF&E) in Cost Basis

Reasonable costs of Furniture, Fixture and Equipment may be included in the mortgageable project costs.

11. Reserve for Replacement and PCNA Requirement

For new construction or substantial rehabilitation projects, the minimum reserve for replacement deposit will be the higher of:

- a) the amount currently required by the Section 221(d) (4) program, or
- b) \$250 per unit per year.

In order to avoid over-funding reserve for replacement accounts for high cost properties with low reserve for replacement needs, waivers of the formula based calculation of reserve for replacement deposit will be considered if the formula approach results in a per unit per annum deposit requirement of greater than \$500. The Multifamily Hub Director's approval of a waiver request must be supported by the Lender's third-party Architecture,

Engineering and Cost Analyst documentation and conclusion that a lesser amount is justified.

Projects must obtain a new PCNA every 10 years with the reserve for replacement deposit adjusted based on the results of the PCNA. HUD Asset Management staff must review and concur or non-concur on the deposit requirements. Development staff will consider this determination and make a final determination of the reserve requirements. The reserve schedule and deposit requirements required by the Firm Commitment will be applicable during the first ten year term of the mortgage.

12. Operating Deficit Escrow Requirements for New Construction/ Substantial Rehabilitation.

The operating deficit escrow provides funding for operating expenses and debt service when net income is not available during the initial lease up period. This escrow is not mortgageable and the unused portion is returned to the Borrower. The appraiser will calculate the number of months for an operating deficit and the estimated amount for that period of time, according to outstanding guidance. The underwriter will analyze the appraiser's estimate and may adjust it if appropriate.

There is no increase in the operating deficit escrow requirements described in the MAP Guide for substantial rehabilitation projects with at least 90% project based rental assistance. For LIHTC projects with a funded operating deficit reserve held by the partnership (even though controlled by the investor and not by HUD or the Lender), the funded reserve will be credited towards the increased reserve requirements. The FHA controlled accounts must still meet the current operating deficit requirements as described in existing guidance.

For market rate or affordable new construction, and for substantial rehabilitation projects in which there will be significant tenant displacement resulting in negative cash flow during the rehabilitation period, operating deficit escrows will be the greater of:

- a) What the appraisal and underwriting analysis determines to be appropriate, or
- b) Three percent (3%) of the mortgage amount, or
- c) Four (4) months debt service (Principal & Interest and Mortgage Insurance Premium) if the property is a garden apartment, or six (6) months debt service (Principal & Interest and Mortgage Insurance Premium) if the property is an elevator building where a single Certificate of Occupancy must be issued before any of the units or any of the entire floors can be rented.

HUD will consider lender requests for Initial Operating Deficit draws during lease-up. Lender requests must be accompanied by: a) a review and analysis of the monthly accounting reports detailing progress on lease up as compared to the lease up projections used in underwriting, and b) an updated calculation of the sufficiency of the escrow. This analysis and calculation is particularly important if the project is experiencing substantial variations from its lease up projections. HUD Mortgage Credit staff will consult with

Asset Management staff prior to approving the release. Unused amounts will be released upon the Lender's request at the later of 12 months after final endorsement or when the project has demonstrated to the HUD field office's satisfaction that the project has achieved 6 months of break-even occupancy. For garden apartment projects consisting of separate buildings, each of which is leased up separately, HUD will consider partial releases of the operating deficit escrow as individual buildings achieve 6 months of break-even occupancy. The Lender is responsible for insuring funds are released solely for project operating needs.

Other than as noted in this Housing Notice, outstanding guidance for the operating deficit escrow remains in effect.

13. Working Capital Escrow Requirements for New Construction/ Substantial Rehabilitation.

There is no increase in the working capital escrow requirements described in the MAP Guide for substantial rehabilitation projects with at least 90% project based rental assistance. For LIHTC projects with a funded working capital reserve held by the partnership (even though controlled by the investor and not by HUD or the Lender), the funded reserve will be credited towards the increased reserve requirement, although the FHA controlled account must still meet the current working capital escrow requirements as described in existing guidance.

The working capital escrow requirement for new construction transactions will be 4% of the mortgage amount, half of which will be a construction contingency for cost overruns and approved change orders. A separate section to the working capital escrow will govern the 2% construction contingency. The construction contingency portion of the escrow will be refunded to the developer at final endorsement if not used. Change orders funded from the contingency portion of the working capital escrow will not be considered as the basis for a request for an increased mortgage amount.

As is the case with operating deficit escrows, these funds are not mortgageable and the unused portion will be returned to the Borrower if not needed. The working capital portion of the escrow will be released upon the Lender's request at the later of 12 months after final endorsement or when the project has demonstrated to the HUD field office's satisfaction that the project has achieved 6 months of break-even occupancy.

14. Insurance Upon Completion

Projects that apply for insurance upon completion (without insured construction advances) must meet the operating deficit escrow and working capital requirements for projects with insurance of advances as outlined in this Notice except for the extra 2% construction contingency section of the working capital requirement.

15. Other Issues

Except where specified in this Housing Notice, the revised Section 221(d) (4) underwriting standards, reserve and processing requirements are applicable to transactions processed

under the Section 220, 221(d)(3), 231 and 241(a) programs. This guidance does not supersede requirements for those programs on matters not addressed in this Housing Notice.

Break-even occupancy in the discussion of working capital and initial operating deficit escrow releases is defined as 1.0 debt service coverage, based on all sources of project income including ancillary income, for 6 consecutive months.

The same requirements for condominium ownership regimes described above in the Section 223(f) program guidelines apply to proposed new construction and substantial rehabilitation projects.

IV. Processing Improvements

A. New Project Concept Meetings

All Section 220, 221(d)(3), 221(d)(4), 231 and 241(a) projects (both market rate and affordable) must participate in a concept meeting with the program center, either in person or by teleconference, where the project has an early review before submitting a pre-application or direct to Firm application. Concept meetings are not required, but are strongly encouraged for Section 223(f) transactions. The submissions required from the Lender for a concept meeting review should address the following items, to the extent possible at this preliminary stage.

New Construction/Substantial Rehabilitation Proposals:

- Section of the Act
- Number of market rate and affordable units
- Projected mortgage amount
- Basic information on developer and principals
- Management company
- General contractor
- Previous HUD experience
- Geographic location with map
- Photographs of the subject and immediate surroundings
- Site improvements (existing/proposed)
- Commercial component – discuss potential tenants
- Amenities
- Community / city / state support
- Green / sustainability Issues
- Development status (e.g., have any permits/approvals been obtained?)
- Discuss general market conditions, competitive properties and comparables
- Environmental issues
- Potential risks and mitigating factors
- Any anticipated waiver requests

Refinancing or Acquisition Proposals:

- Section of the Act
- Number of market rate and affordable units
- Projected mortgage amount
- Mortgage term and estimated remaining economic life
- Refinance or acquisition
- Basic information on developer and principals
- Management company
- Previous HUD experience
- Geographic location with map
- Photographs of the subject and immediate surroundings
- Actual and effective property age / class
- Physical condition
- Prior / proposed renovations (per unit cost)
- Discuss eligibility for Section 223(f) versus substantial rehabilitation
- Amenities
- Existing debt / cash out
- Current occupancy (physical / economic)
- Income and expenses
- Discuss green / sustainability issues as appropriate
- Discuss general market conditions, competitive properties and comparables
- Environmental issues
- Actual / potential risks and mitigating factors
- Any anticipated waiver requests

The Lender should complete the form HUD-92013, “Application for a Multifamily Housing Project” to the extent possible.

Where practicable, site visits by the appropriate Program Center staff are encouraged. The Program Center will respond in writing (either by e-mail or more formally) within 5 working days of the concept meeting/site visit. Depending on the completeness and quality of the submission, the Program Center may recommend or not recommend that the Lender make an application, or they may request additional information or specify conditions or recommendations for the Lender and sponsor to consider. Consideration should be given to the effect on other FHA-insured projects in the subject’s market area that are already in the pipeline, developer experience and overall feasibility based on the exhibits and information presented.

B. Two Stage Processing

Market rate Section 220, 221(d), and 231 applications must be submitted under 2 stage processing (i.e., including a Preapplication submittal) and may not apply directly for a Firm Commitment. The Hub Director may waive 2 stage processing and allow a direct to Firm application for a stable, occupied market rate substantial rehabilitation property that, during the rehabilitation period, will not have: a) major rehabilitation or unit reconfiguration, b) tenant displacement except for short periods during interior rehabilitation of a unit, c) a reduction in current occupancy levels, d) negative cash flow, or e) for properties in stable markets for which a Preapplication Invitation letter

recently expired on a substantially unchanged proposal. Affordable properties (as defined above), or those with 90% or more rental assistance, may submit a Section 221(d) (4) application directly for Firm Commitment.

C. Partial Electronic Submission

Lenders must submit an original and 1 hard copy of the underwriting file, exhibits and third party reports and must submit an electronic version of these materials on a disc or a removable drive.

D. MAP and Traditional Application Process (TAP) Processing

All MAP eligible projects must be submitted using MAP processing and may not be submitted under TAP.

E. 2530 Approval

Firm Commitments or Invitation letters may be issued conditioned on 2530/APPS approval, assuming no critical findings and that the 2530 flags can be resolved without being presented to the Multifamily Participation Review Committee.

F. Market Studies

Market studies are not required for properties with at least 90% of units covered by a rental assistance contract and no rent increase.

V. Implementation

A. Changes to the Section 220, 221(d)(3), 221(d)(4), 231 and 241(a) programs will be implemented as follows: i) 60 days after the effective date of the Housing Notice for any new pre-applications, (existing or previously submitted pre-application submissions are covered under iii. below), ii) up to 120 days for projects with outstanding invitation letters, or such shorter time as the invitation letter provides, so long as a complete application for Firm Commitment can be submitted within the time allowed by the invitation with no extensions, or iii) up to 90 days after the effective date of the Notice for any complete new applications for direct to Firm Commitments.

B. Changes to the Section 223(f) and 223(a) (7) programs will be implemented 60 days after the effective date of the Notice for any applications or application fees not submitted before that date.

C. Incomplete applications that are submitted before the implementation dates will be returned to the Lender and the revised underwriting standards will be applicable upon resubmission. Materially deficient applications submitted by a Lender pre-maturely in order to avoid application of more stringent underwriting parameters will be referred to the Lender Quality Monitoring Division for review.

- D. Any extensions of the implementation dates for individual projects must be approved by HUD Headquarters and will only be considered in cases the Lender and Borrower have demonstrated to HUD's satisfaction they have done everything within their control to meet the deadlines imposed and that a short extension is warranted to permit the transaction to achieve closing.

VI. Conclusion

The Department will continue to monitor market conditions and the impact of these risk mitigation measures. Additional guidance will be published based on experience and industry input. Questions relating to this Housing Notice should be directed to Joyce Allen, Director of Multifamily Development, at (202) 402-2471. Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-877-TDD-2HUD (1-877-833-2483).

_____/S/_____
David H. Stevens
Assistant Secretary for Housing –
Federal Housing Commissioner

Attachments:

- Attachment A – Sample Schedule of Real Estate Owned
- Attachment B – Sample Schedule of Mortgage Debt