U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

August 11, 2010

MORTGAGEE LETTER 2010-25

TO: All FHA-Approved Multifamily Mortgagees

SUBJECT: Processing Instructions for Refinancing Cooperative Housing Projects under Section 207 pursuant to Section 223(f)

Purpose

This Mortgagee Letter (ML) provides processing instructions and guidance to issue Mortgage Insurance for refinancing Cooperative Housing Projects under Section 207 pursuant to Section 223(f) of the National Housing Act. The Department is currently in the process of amending 24 CFR §200.24 to allow for Cooperative mortgagors. Until the regulation is amended, it will be necessary to apply for a waiver of 24 CFR §200.24 in its entirety. The waiver request should originate from the Hub Director and be sent to the Director of Multifamily Housing Development. This ML applies solely for refinancing a project and does not apply to projects that include an acquisition. Please note that proposed conversions or projects undergoing conversion to cooperatives are not eligible.

Background

Cooperative Ownership is popular in certain parts of the country, especially for low-to-moderate-income occupants. HUD already insures mortgage loans to facilitate the construction and substantial rehabilitation of Cooperative Housing projects under Section 213 of the National Housing Act. Facilitating the refinancing of a Cooperative through mortgage insurance issued under Section 223(f) of the National Housing Act would help to further the Department's mission by assisting eligible Cooperative projects to obtain refinancing to make necessary repairs and/or consolidate more expensive outstanding debt, thereby serving to preserve the affordable housing stock. Refinancing the existing underlying mortgage is considered to be a better alternative than expending a Cooperative's reserve fund, which would have a negative impact on its financial strength. Refinancing would also help to avoid the need for a special assessment, which could harm low-to-moderate income occupants, especially those on a fixed income

I. Program Requirements

The Underwriting summary submitted with the application must thoroughly demonstrate compliance with all program requirements.

A. Loan Parameters. In accordance with Chapter 3.8.P of the Multifamily Accelerated Processing (MAP) Guide, HUD will insure a mortgage for a maximum term of 35 years or 75% of the remaining economic life of the property, whichever is less. The maximum insurable mortgage amount shall be the lesser of these following parameters as they relate to the criteria set forth on the form HUD-92264-A, "Supplement to Project Analysis": (NOTE- An equity take out is not permitted.)

Criterion 1	Mortgage or Loan Amount Requested in Application.
Criterion 3	Amount Based on Value or Replacement Cost. The lesser of market value, valued as a Market Rate Rental Apartment Project multiplied by a loan ratio of 65%, or the Gross Sell-off Value, as a Market Rate Cooperative Project multiplied by a loan ratio of 55%. (Value definitions are contained in Section II.B.)
Criterion 4	Amount Based on Limitations per Family Unit. Use Section 207 Statutory per unit limits, adjusted by the local Program Center High Cost Percentage for the locality. Follow the outstanding instructions for Criterion 4.
Criterion 5	Amount Based on Debt Service Ratio. A mortgage amount supported by 1.000 debt coverage based on the projected Net Operating Income (NOI) as an existing Cooperative project, which is NOI multiplied by 100% noted on line "5.e".[*]
Criterion 7	Criterion 7 shall not be completed since acquisitions are ineligible.
Criterion 10	Amount Based on Existing Indebtedness, Repairs and Loan Closing Charges. Follow outstanding instructions. The cost to refinance which includes the funding if applicable, the Initial Funding of the Replacement Reserve and the Initial Deposit to the General Operating Reserve (see Section I.F). No equity out is permitted under Section 223(f) when refinancing Cooperatives, accordingly, the calculation for this criterion stops at line "10.g".

[*] In addition to the calculation of Criterion 5, the MAP Underwriter shall perform a feasibility test comparing Criterion 5 as calculated above to a Criterion 5 calculation on a mortgage amount supported by a 1.538 debt coverage based on projected NOI as Market Rate Rental Apartment project, which is NOI multiplied by 65%. This will be reported on page 4, "Remarks" of the form HUD-92264-A. If the amount based on NOI as an existing Cooperative project exceeds the amount based on NOI as a Market Rate Rental project, the underwriter must comment on the feasibility of the project to continue as a Cooperative.

Criterion 11 Amount Based on Deduction of Grants and Gifts and Loans. Line "11.a" shall be the cost to refinance plus FHA Mortgageable items taken from Line "10.g". Line "11.b" shall be total of grants, gifts and loan intended to offset the cost of FHA Mortgageable items. Line "11.c" shall be Line "11.a" minus Line 11.b".

B. Eligible Mortgagors. Eligible Mortgagors include nonprofit Cooperative Ownership Housing corporations or nonprofit Cooperative Ownership Housing trusts regulated under State law and regulatory agreements that require membership eligibility and transfer of membership in a manner approved by the Secretary.

C. Application Processing. Applications for Cooperatives are processed in accordance with the current 223(f) instructions except as modified in this ML. MAP processing must be used in all cases except for those that involve an identity-of-interest between the mortgagor and Lender, which shall be the only reason to use Traditional Application Processing.

D. Required Exhibits. All exhibits normally required for a Section 223(f) application must be submitted with the following modifications and additions.

1. Rent Roll. A Rent Roll is a required exhibit under Section 223(f). The Rent Roll should be modified to indicate each shareholder's name, unit location, mailing address, whether or not the unit is owner occupied, whether or not the unit is subsidized, date of occupancy, ownership percentage, amount of monthly maintenance charge, any special assessments and past due balances of 30 days or more. For any units subject to rent control, the actual rent must be substituted for the maintenance fee amount. The monthly maintenance charge must be used for all other units, except those subject to rent control. It should be noted that project-based Section 8 or any other subsidized rent program is not considered to be a form of rent control. The Rent Roll should be submitted as an Excel file.

2. Cooperative Membership Exhibit. Subsequent to issuance of commitment and prior to the setting of a date for closing, the mortgagee must submit a statement of the cost to the mortgagor and the Cooperative Membership Exhibit, form HUD-93203. The number of members must equal the percentage (or number) of the total number of units as specified in the commitment.

3. Original Project Prospectus (if available). The prospectus is prepared at the time of the original public offering and contains a great deal of useful information for technical discipline processing by HUD as well as the underwriter and preparers of third-party reports.

4. Financial Statements for the Past Three Years. Follow the current instructions contained in chapter 7.7.B of the MAP Guide. The Lender should review and evaluate any qualifications contained in the reviews to ensure the financial statements reliably represent the property's operating history and the assumptions relied on in the underwriting conclusions. The Lender should also pay particular attention to the history of total past due balances of maintenance fees and special assessments. The total amount of the unpaid balance (30 days or more) for maintenance charges and special assessments as shown in the rent roll (see I.D.1) must not exceed 5% of the gross annual income.

5. Environmental Exhibits.

    a. Contamination Analyses. A Phase I Environmental Site Assessment (Phase I ESA), if necessary (based on the Phase I ESA) a Phase II ESA, and if further necessary (based on the Phase II ESA), a remediation plan are required. Details of these submissions are described in Section 9.3 of the MAP Guide.

    b. Environmental Report. As described in Section 9.5 of the MAP Guide, an Environmental Report is required. The lender is not to submit the form HUD 4128 or the associated Sample Field Notes Checklist (SFNC) but may pattern the Environmental Report on factors 9 through 24 of the SFNC, as well as the factors described in Section 9.5 of the MAP Guide. Additionally, as described in 9.5B, asbestos requirements must be discussed in the Environmental Report for any structures built before 1978. Also, as described in 9.5D, the lender is required to submit a letter to the State Historic Preservation Officer (SHPO), and include this letter as well as any response from the SHPO in the Environmental Report.

6. Additional Third-Party Reports. HUD reserves the right, at its discretion, to require additional specialized reports to ascertain the safety and soundness of the property and its amenities as to their suitability as collateral for long-term financing.

7. Organizational Documents and Minutes. The following additional exhibits are required:

    a. Certificate of Incorporation FHA Form No. 3234-B.

    b. Resolution of Board of Directors to Mortgage Cooperative.

    c. Shareholders authorization to Mortgage Cooperative.

d. Resolution of Board of Directors adopting FHA Form No. 3245, "Model Form of By-laws."

e. Shareholders authorizing adoption of FHA Form No. 3245, "Model Form of By-laws."

f. Minutes of the last six Board of Directors (BOD) meetings.

g. Resolution of Board of Directors adopting FHA Form No. 3237, "Model Form of Occupancy Agreement."

h. Resolution of Board of Directors adopting FHA Form No. 3237-A, "Model Form of Sublease."

E. Project Eligibility. The property must contain at least 5 residential units with complete kitchens and baths, and have been completed or substantially rehabilitated for at least 3 years prior to the date of application for mortgage insurance. Properties that were substantially rehabilitated with HUD-Insured Multifamily mortgages that have been completed with an expired latent defects guarantee are exempt from the 3 Year-Rule. If the Cooperative was a conversion, the conversion must have been completed at least three years prior to the application date. Proposed conversions or projects undergoing conversions are not eligible. Projects with a recent or unresolved vacancy history, or history of shareholders not paying dues and other co-op obligations, will not be considered for mortgage insurance. The project must be fully subscribed, with no units owned by the original developer, prior to endorsement, and must meet these additional criteria:

1. Project Design. The project must be designed for primary residence only. Timeshares, resorts, Cooperative hotels, or rental pools are not permitted. Section 513 of the National Housing Act prohibits the use of the Mortgage Insurance programs for transient or hotel purposes. The mortgagor and individual shareholders cannot execute Occupancy Agreementsfor less than 30 days nor provide occupants with hotel services such as maid service, furnishing and laundering of linens, room service and bellboys. Units may not be sub-leased without the consent of the Cooperative Corporation.
2. General Market Conditions. The Property must be located in an area evidencing strong market understanding and acceptance of Cooperative housing. Financing for the purchase of individual shares must be readily available from mortgage bankers/brokers, banks or saving and loan institutions. The Underwriting summary shall cite recent sales within the building and indicate the type of financing utilized.

3. Repair Threshold. Section 223(f) is not intended to be used to finance substantial rehabilitation. A project cannot be processed under Section 223(f) if it meets the current requirements for substantial rehabilitation. Projects that are not eligible for mortgage insurance under Section 207 pursuant to Section 223(f) should consider Section 213 or Section 221(d)(3).

4. Fair Housing / Equal Opportunity Requirements. All other applicable program requirements for the Section 207 pursuant to Section 223(f) program must be met, including compliance with applicable Civil Rights Laws, including the nondiscrimination and affirmatively furthering fair housing provisions of the Fair Housing Act, and applicable accessibility requirements for persons with disabilities (see 24 CFR 5.105(a) for a listing of Federal Civil Rights requirements).

    a. Affirmative Fair Housing Marketing. The Affirmative Fair Housing Marketing Requirements (24 CFR Part 200, Subpart M) apply to all insured multifamily projects of five or more units. Mortgage Insurance under Section 207 pursuant to Section 223(f) of the National Housing Act while covered by the nondiscrimination provisions of the Fair Housing Act and Executive Order 11063, is exempt from the submission of a written plan. However, a Section 223(f) applicant is required to conceive, implement and maintain records for its affirmative marketing efforts. Except in the case of a project specifically designed exclusively for the elderly (see below), the mortgagor must certify that it will not discriminate against families with children.

    b. Accessibility for Persons with Disabilities. This is required for properties built after March 13, 1991, containing Fair Housing Act violations. If a project built after March 13, 1991, is submitted for Section 223(f) refinancing and the Project Capital Needs Assessment (PCNA) inspection reveals that it contains violations of the Fair Housing Act construction standards, the Department must require that the owner correct the violations as a condition of insurance. The extent of the violations and the cost of correction will determine whether the project is feasible as a Section 223(f) or whether to resubmit it as a substantial rehabilitation. In no case may the Department insure such a project with outstanding Fair Housing Act violations.

5. Elderly Developments - (aka Golden Age Cooperatives). In refinancing of the underlying mortgage for an existing Cooperative project designed for the elderly, the Department defines the term "elderly person" in the National Housing Act (NHA) as a household composed of one or more persons at least one of whom is 62 years of age or more at the time of

initial occupancy. Waiver of this definition is not permitted under any circumstances. It is noted that this definition differs from the definition in use for Section 213 of the NHA. The Cooperative shall not provide mandatory meals and services such as those associated with retirement service centers. No non-shelter services can be a mandatory condition of occupancy and must be reviewed by the MAP Lender and approved by the Field Office for reasonableness. Non-shelter spaces already constructed for projects with current HUD-insured mortgages may include formal dining areas with meal services to be provided on an optional basis. All Cooperatives can provide modest kitchen equipment in a non-shelter space for the use of occupants or for catering services. The kitchen should be sufficient in size to support sanitary requirements. Additional requirements related to the provision of meals are as follows:

a. Any meal service must be provided on an optional basis.

b. The cost of meals may not be included in the residents' rental charges.

c. The costs associated with the operation of the meals service are the responsibility of the entity that operates the optional meal service.

d. The mortgagor may receive payment from the operator of the meals service. In such cases, this revenue may not be included in the underwriting of the project, as this service is optional for each resident, thereby potentially producing a revenue stream that is both unpredictable and unreliable.

e. A determination should be made by the Lender that the expenses associated with a third-party meal provider will not increase the project risk.

f. Any meal service must be operated by a meal provider licensed under State or local law and in compliance with current health and safety requirements for food service providers.

g. Local HUD Counsel must determine that the granting or revocation of any licensing required to operate a proposed meal service will not jeopardize the ability of the project to operate as Cooperative Housing in accordance with the requirements of HUD's Regulatory Agreement.

h. Costs associated with developing a facility insured under Section 223(f) to include a meal service may be considered in the mortgage, subject to outstanding requirements limiting non-shelter space and commercial areas.

6. Owner Occupancy. At least 75% of the total number of residential units must be occupied by Cooperative members at the time of endorsement, and no more than 25% of the units may be owned by investors.

7. Vacancy Rate. The project should not have a vacancy rate greater than five percent. A vacancy rate above five percent may indicate a weak or problematic project or market. If an application is presented with a higher vacancy rate, the underwriter must provide convincing market evidence to support the transaction in the Underwriting summary.

8. Turnover Rate. The sales history of the complex should display a healthy turnover rate to demonstrate that the project is viable and that there is demand for the units. If the turnover rate is less than five percent of the total number of owner-occupied units per year, the underwriter must determine the reasons for the low turnover rate and why it does not pose an unacceptable risk. This must be documented in the Underwriting summary. However, it should be noted that a project and/or market area may have a historically low turnover rate due to its popularity as a source of affordable housing.

9. Adequacy of the Proposed Carrying Charges. The carrying charge must be sufficient to adequately maintain the project at a level that would make it suitable as security for a Long-Term mortgage. The Underwriting summary must contain an analysis of the Appraiser's findings regarding the adequacy the proposed carrying charge that will be in place after refinancing has occurred. In addition, there must be a discussion of the Cooperative project's policy and history regarding increasing the carrying charge.

   The Cooperative's Bylaws or other appropriate organizational documents must contain a provision that requires an annual increase in the carrying charge based on inflation, in order to address increases in operating expenses.

10. Carrying Charge Increase. In general, the debt service resulting from the proposed mortgage should not require a carrying charge increase of more than five percent. This amount may be exceeded, so long as all of the following requirements are met:

    a. The carrying charge is below market for properly maintained similar projects, and is not sufficient to adequately maintain the project.

b. The Board of Directors must approve the carrying charge increase in accordance with the FHA Model Form of By-laws, FHA Form No. 3245.

c. An analysis of the demographic data in the appraisal report must indicate the new maintenance fee would be affordable for the typical resident.

d. Market analysis of the proposed maintenance carrying charge indicates that it is within market limits for similar projects in the subject's market area.

11. Commercial Space Limitations. The current Section 223(f) parameters shall be followed. Commercial area shall not exceed 20% of the total net rentable area of the project and commercial income shall not exceed 20% of effective gross income.

12. Ownership of Commercial Space/Parking. Commercial and parking space at a Cooperative Housing project may or may not be owned by the Cooperative. Only those spaces that are owned by the Cooperative may be included as part of the collateral.

13. Ground Leases. According to Chapter 7.16.B of the MAP Guide, Ground Leases must conform to the FHA Lease Addendum Form FHA-2070. The term of the lease addendum may be varied to conform with applicable State and local law, except that the HUD Closing Attorney must approve:

a. The legal need for any proposed lease term changes, and

b. That any term changes are consistent with the following requirements:

1) Term is 99 years and is renewable, or

2) Term is at least 50 years from the date the mortgage is executed (where a lease is on trust/other land on a reservation the HUD Closing Attorney must ensure that the lease provisions are coordinated with Bureau of Indian Affairs' requirements).

F. General Operating Reserve (GOR). Cooperatives are required by the Regulatory Agreement, FHA Form No. 3225 to establish and maintain a GOR which is a percentage of the monthly carrying charges. The carrying charge is the sum of all project expenses, replacement reserve, taxes and debt service.

1. GOR formula.

a. The GOR is maintained by a monthly payment of 3% of the monthly carrying charges.

b. When the GOR account reaches 15% of the annual carrying charges, the monthly rate may be reduced to 2%.

c. When the GOR account reaches 25% of annual carrying charges, monthly accruals may be discontinued until the account is reduced below 25%.

d. Anytime the GOR falls below the 25% level, monthly payments to the account shall be resumed at a 2% to 3% rate, as noted above, until the 25% level is restored.

2. In addition to any Initial Deposit to replacement reserve, the Cooperative mortgagor may be required to make an Initial Deposit to the GOR not to exceed 15% of the annual carrying fee. The Initial Funding of the GOR using this provision may be included in the cost of refinancing. However, no more than an amount equal to 15% of the annual carrying fee may be funded with mortgage proceeds.

G. Model Forms and Closing Documents. Use Handbook 4550.3, Appendix III (modified for Section 223(f)). Cooperative Organizational forms and documents must be reviewed and approved for legal and programmatic compliance prior to the issuance of a Firm Commitment. Use FHA Required Closing Instruments, FHA Form No. 3257-B, also set out in Handbook 4550.3, Appendix 3-10. (See I.D.7)

II. Technical Processing.

A. Architectural and Cost Processing for Cooperatives. Follow the current instructions for Section 223(f). A summary of these procedures is outlined below.

1. Architectural Analysis. Lender will submit deliverables as specified under the present guidance for Section 223(f) to the HUD processing office. The HUD Architectural Analyst will examine the Lender's PCNA Report, the project's prospectus, the Underwriting summary and the Mortgagor's exhibits, as required in the MAP Guide. The HUD analyst will review the quality of the Lender's report and the transaction itself. The HUD analyst will not reprocess the case. However, if the HUD analyst determines that certain underwriting conclusions are not supportable and affect HUD's risk, the analyst may recommend that the Lender modify the application or recommend a rejection. The Team Leader will approve, reject or modify the recommendation of the HUD Architectural Analyst.

2. Cost Processing. HUD Cost Analyst will review Lender exhibits as required in the MAP Guide and will recommend either acceptance or rejection of the Cost portion of the Firm submission. HUD cost recommendations will be based on review of:

    a. Repair estimate based on the PCNA and compared with HUD data.

    b. Lender's estimate for Initial Deposit to Replacement Reserve contained in the PCNA and compared with HUD data.

    c. Property Insurance Schedule.

    d. Any information produced by the Lender's Architectural Analyst which may affect cost.

3. PCNA. The primary purpose of the PCNA for a Cooperative project is to assess the Capital Needs of the project with the exception of any elements owned by the individual shareholders. So, it is very important to ascertain exactly what items are the sole responsibility of the Cooperative. In some cases, appliances, kitchen cabinets, etc. may actually be owned by the Cooperative. The interior of individual units are still inspected in the same manner as with apartments. Any hazards or defects that would affect safety and marketability of the Cooperative should be noted even if it is an individual shareholder's responsibility. These items must be corrected at the shareholder's expense prior to endorsement. Mortgage proceeds must only be used for repairs of property owned by the Cooperative.

B. Valuation Processing; Appraisal Scope-of-Work for Cooperatives. There can be great variation in how a Cooperative is structured. According to the Uniform Standards of Professional Appraisal Practice (USPAP), the determination of Scope-of-Work is an ongoing process in an assignment. Information or conditions discovered during the course of an assignment may cause the appraiser to reconsider the scope-of-work. Therefore, after appropriate consultation with Headquarters Multifamily Development, the guidance set forth below may be modified on a case-by-case basis to assure compliance with USPAP and that the results of the appraisal assignment will be reliable for making underwriting decisions. There are four major elements for the appraisal assignment: General Requirements, Valuation as a Market Rate Rental Project, Market Analysis for Continued Use as a Cooperative, and Hypothetical Gross Sell-Out Value as a Cooperative.

    1. General Requirements.

        a. Selection of the Appraiser. The Lender must select a qualified Appraiser in accordance with current instructions. It should be noted that the appraisal of a Cooperative is very specialized. Lenders should base their selection of an Appraiser on their experience for this type of assignment and upon their familiarity with the subject's market area.

b. Value Definition. Appraisers must use the following definition published by Federal Regulatory agencies pursuant to Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 between July 5, 1990, and August 24, 1990, by the Federal Reserve System (FRS), National Credit Union Administration, Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the Office of Comptroller of the Currency (OCC). This definition is also referenced in regulations jointly published by the OCC, OTS, FRS, and FDIC on June 7, 1994, and in the Interagency Appraisal and Evaluation Guidelines, dated October 27, 1994:

"Market value means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby;

i. buyer and seller are typically motivated;

ii. both parties are well informed or well advised and acting in what they consider their own best interests;

iii. a reasonable time is allowed for exposure in the open market;

iv. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto;

v. and the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale."

The value shall be estimated assuming that all repairs have been completed as of the date of the appraisal.

c. Inspection of the Subject and Comparables. The primary appraiser designated by the Lender and accepted by HUD must physically inspect the subject (both exterior and interior) and all of the comparables used as part of the analysis. The primary appraiser must also sign the Certification within the appraisal report and the supporting HUD forms.

i. The primary appraiser must inspect at least one of each bedroom/unit type. The total number of units inspected must equal or exceed 5% of the total number of units for projects of up to 200 units, or 4% of the total number of units/beds for projects greater than 200 units. If the characteristics and/or condition of the subject indicate that a higher level of inspection is necessary, it is the appraiser's responsibility to expand the scope of the work as is necessitated by the observations made by the primary appraiser during the inspection of the subject. This is especially important where the improvements are high-rise structures whereby individual units within demonstrate varying degrees of light and view qualities. If there are hazardous conditions or other factors that preclude a thorough inspection of the interior, the appraiser must clearly indicate these circumstances in the appraisal report.

ii. Large Projects. For projects exceeding 500 units, the appraiser must consult with the processing office to agree on a reasonable number of units to be inspected. In addition, the appraiser may employ assistants to inspect individual units. The purpose of allowing assistants is to encourage a thorough inspection. The names and qualifications of these assistants must be disclosed in the appraisal report. The assistants are not required to sign the report.

iii. The primary appraiser must inspect all of the comparables used in deriving an estimate of value. This includes land comparables (if applicable), improved comparables sales, expense comparables and rental comparables. The appraiser must verify the condition of the comparables at the time of transfer/rental with management or other personnel familiar with the property. Contact information must be documented in the appraisal report.

d. Required Appraisal Report Exhibits. Photographs (subject, and all comparables including rentals), Regional Map, Location Map, Satellite Scans (if available - Google, Bing, etc.), Flood Hazard Map, Survey (if available), Floor Plans (for each type of unit including accessible being offered - if available), Site Plan (if available), Zoning Map (if available), Tax Map (if available), Land Sales Comparable Map, Rental Comparable Map, Improved Sales Comparable Map are required with all submissions.

e. Review of the PCNA and Phase I ESA. The appraiser must review the PCNA and ESA prior to completing the assignment, comment on any remarkable findings and their impact (if any) on value.

f. Required Approaches. The Comparable Sales Approach and Income Approach with both Capitalization and either Gross or Effective Gross Income Multiplier must be completed. The Replacement Cost Approach is optional for projects that are more than 10 years old; however an estimate of the land value must be made and recorded in Section "O" (Remarks) on the form HUD-92264.

g. Estimation of Remaining Economic Life (REL). REL is defined as:

> "The estimated period during which improvements will continue to contribute to property value; an estimate of the number of years remaining in the economic life of the structure or structural components as of the date of the appraisal".

Guidelines require that for existing properties, the maximum mortgage term is limited to the lesser of 35 years, or 75% of the REL. Estimation of the remaining economic life is first accomplished by determining the economic life of the improvements (as new) through market analysis and/or an appropriate reference source. The appraiser then reduces the economic life (as new) by the effective age to determine the estimated remaining economic life. The effective age is determined by the appraiser based on the actual condition of the subject considering all applicable forms of obsolescence and depreciation, and after assuming the required repairs to be made as specified in the PCNA as a condition of refinancing. The methodology and reference/data sources used by the appraiser must be clearly set-forth in the self-contained report and must consider all of the following factors:

i. The economic background of the community or region and the ongoing demand for accommodations of the type represented.

ii. The relationship between the property and the immediate environment. Older properties may possibly enjoy legally non-conforming use since they pre-dated any form of real property zoning for the neighborhood. Observations within the neighborhood in which the subject is situated might reveal a conflicting relationship. This should be fully explored to establish or debunk any potential existence of external obsolescence.

iii. To the extent possible, the appraiser should analyze architectural design, style and utility from a functional point of view and the likelihood of obsolescence attributable to new inventions, new materials, changes in building codes, and changes in tastes. It is recognized that this sort of analysis requires speculation. The appraiser should indicate in the Scope-of-Work the steps taken to accomplish this requirement.

iv. Trend and rate of change in the characteristics of the neighborhood that affect property values and their effect on those values.

v. Workmanship and durability of construction and the rapidity with which natural and man-made forces cause physical deterioration.

vi. Physical condition and the practice of owners and occupants with respect to maintenance, the use or abuse to which the improvements are subjected, the physical deterioration and functional obsolescence within the subject property.

HUD considers the estimate of the REL to be vital in determining the maximum insurable mortgage since it directly impacts the amortization period. An over-estimate of the REL can lead to an erroneous expansion of the dollar amount and term of the mortgage, thereby posing a greater and possibly unacceptable risk to the Department. An underestimate can unfairly penalize a project. HUD Review Appraisers should carefully scrutinize the methodology used in estimating the REL.

h. HUD Forms. All of the usual forms for Section 223(f) should be employed, (92264, 92264-A 92273 and 92274) following the outstanding instructions for Section 223(f). The form HUD-92264 shall be completed based on usage as rental apartments. The Gross Sell-Out Value should be summarized in Section “O”; (Remarks).

i. Additional Appraisal Work Required by the Lender or other Intended Users. The appraiser is bound by USPAP to complete the appraisal assignment in compliance with the requirements of the person or entity who ordered the report and to satisfy the needs of identified intended users.

j. Reconciliation and Conclusion. The appraiser must briefly reconcile the information presented; clearly indicating what data is the most relevant and supports the report's conclusions. The conclusions must indicate whether or not the subject can expect to enjoy long-term use as a Cooperative; and whether or not the proposed maintenance fee is within market limits and is affordable for the typical shareholder.

k. Report Content and Format. The appraiser must explain logically and convincingly the reasoning that leads to his or her conclusions. The flow of information must be orderly and progressive. The format and level of information necessary in the report is dependent on the intended use and needs and requirements of the intended users, being the Lender and HUD, and should be based on the availability of relevant market information. There should be an appropriate balance of detail with brevity. The substantive content of a report determines its compliance.

2. Valuation as a Market Rate Rental Project. Follow all current procedures for Section 223(f) Appraisal and Appraisal Review, including these additional instructions:

   a. Use of the Subject. The appraiser shall assume a hypothetical use of the subject as a Market Rate Rental Apartment project, except that income from any units subject to rent control will assume the current controlled rental amount.

   b. Estimate of Effective Gross Income. The estimate of Effective Gross Income shall be made using Market Rental Housing comparables that are equivalent to the subject in location, size and style. Actual rents should be used for any rented units in the Cooperative that are subject to rent control. It should be noted that project-based Section 8 or any other subsidized rent program is not considered to be a form of rent control. Market Rents must be used for any subsidized units. Vacancy and collection losses should also be market derived, but in no event will a residential occupancy rate greater than 95% and a commercial occupancy rate greater than 90% be used.

c. Expense Analysis. The Expense Analysis should accurately reflect usage as a Market Rate Rental project. Appropriate weight should be given to the most recent three year history for items such as repairs, maintenance and common utilities. Other items such as taxes and management expense should be based on Rental Apartment Market data.

3. Market Analysis for Continued Use as a Cooperative. The appraisal report must also contain a Level C Market Analysis of the local market with an emphasis on Cooperatives. The purpose of the analysis is to determine the ability of the subject to continue usage as a Cooperative Housing project. A brief outline of a Level C analysis is as follows:

   a. Location. This includes a general description, specific analyses of site linkages and urban growth determinants and detailed competitive location rating.

   b. Demand Analysis. There must be a discussion of general evidence of sales/leasing activity, general city/area growth trends, market absorption, demand and need forecast based on population, employment and income and a demand forecast of the subject market segment.

   c. Competitive Supply Analysis. This must include vacancy rates for comparables and from market surveys (secondary data), field research on all competitive and proposed properties, building permit analysis, identification of proposed sites, and a detailed competitive amenities rating.

   The detailed requirements for performing a Level C analysis can be found in "Market Analysis for Real Estate", published by the Appraisal Institute. The study must also address these additional requirements.

   d. Assumptions. The study should assume that management has budgeting and operations under control; which can be demonstrated by an illustration of past years maintenance charge history.

   e. Financial Statement Review. Special Assessments should be explained, and a review of the last three years financial statements is required. (See Section I.D.4 for specifications for financial statements). The footnotes to the Cooperative's yearly financial statement are a typical source of details regarding past, current and upcoming issues. There should be a discussion of any material or atypical items as to their impact on value. In addition, the appraiser will complete a form HUD-92274 using comparable

Cooperative projects and also analyze the past three years records and any unaudited records from the most current period, if deemed reliable, to ascertain if the proposed maintenance charge is adequate to continue operations.

f. Cost of Occupancy/Cost of Ownership Analysis. The typical monthly maintenance charge by unit type should be compared to the competing project's monthly maintenance charges by unit type. This will serve as a variable for Cost-of-Occupancy/Cost-of-Ownership calculations to ascertain and support market-oriented unit pricing. The appraiser will complete a form HUD-92273 for each major Cooperative unit type using other units from other Cooperative projects as comparables to compare monthly maintenance fees and to determine if the proposed monthly fee is realistic and affordable for the subject's market area.

4. Hypothetical Gross Sell-Out Value as a Cooperative. The appraiser will develop a value estimate based on a Gross Sell-Out of all units, using comparable sales analysis and any other industry acceptable methods. The Hypothetical Gross Sell-Out Value is before the application of all costs and entrepreneurial profit associated with a conversion from a rental property to a cooperatively owned property and further assumes a vacant and moderately renovated unit. Additionally, this value is over and above a pro rata share of an underlying mortgage encumbering the premises. Based on the proposed mortgage refinancing, it is considered that such debt conforms to the influencing market parameters. A sample breakdown of the Gross Sell-Out Value is as follows:

Gross Sell-Out Value:	
Gross Sell-Out for Residential Units (453 Rooms x $48,000/Rm)	$21,744,000
Unpaid Balance of Underlying Mortgage	$2,858,300
Total Gross Sell-Out Value and Underlying Mortgage	$24,602,300
Rounded	$24,600,000

5. Appraisal Review. HUD Multifamily Staff Appraisers will review the appraisal in accordance with USPAP Standard 3. The appraisal review must include a comparison of the subject's proposed monthly maintenance fees based on the new financing to what the various units would rent for if the subject were operated as a rental project. A Cooperative Housing project's feasibility for continued use as a Cooperative is questionable if monthly maintenance fees significantly exceed what units could actually rent for. A downward trend in rents versus no change or an upward trend in maintenance fees is an indication of an unhealthy Cooperative Housing project/market.

C. Environmental Processing. The HUD Review Appraiser will follow all applicable instructions in Chapter 9 of the MAP Guide. The Review Appraiser or other designated HUD staff will use the Sample Field Notes Checklist contained in the form HUD-4128 to provide information supporting the conclusions listed page 1 of the form HUD-4128, "Environmental Assessment and Compliance Findings for the Related Laws." Part B of this form does not need to be completed except in extraordinary circumstances (see categorical exclusion in 24 CFR 50.20(a)(5)), but Part A must be completed. It is important to note that the ESA, which is performed as part of contamination analysis in Section 9.3, must be cited as source documentation in Part A, Item 23, and must be attached to the HUD-4128.

D. Mortgage Credit Processing. Follow the current instructions for Section 223(f) modified as follows:

    1. Determination of the Acceptability of the Cooperative Corporation.

        a. BOD Performance History. In processing an application, the Lender will take into account the BOD's ability and willingness to manage the Cooperative within the legal requirements of Section 223(f). The lender will also consider all applicable requirements contained in Chapter 10, Management Analysis, in the MAP Guide.

        b. Ability to Close. It must be determined that the Cooperative organization has the ability to close the transaction in a satisfactory manner and that the sum of the monthly charges to members will be adequate to meet debt service and other ownership expense. It must also be determined that the present members of the Cooperative, as a group, have the ability to provide whatever additional funds may be required to close the transaction.

        c. Credit-Worthiness. It must also be determined that participants have not been debarred or subject to a Limited Denial of Participation, and are otherwise capable of meeting their ownership and management obligations. For the Single Asset Mortgagor Entity, its Officers and BOD Members, and the Management Agent, the review should include the following documents:

            - HUD-92013 SUPPLEMENT
            - HUD-2530 / APPS Clearance
            - Verification of Deposits

d. Other Business Concerns. List of other business concerns, are required for the Officers of the BOD.

e. Adequacy of Monthly/Annual Charges. The underwriter needs to ensure that the sum of monthly charges, as listed on Cooperative Membership Exhibit, converted to an annual basis, is sufficient to meet the HUD-FHA estimate of debt service, Cooperative operating expenses, taxes, special assessments and ground rents, if any, plus a general operating reserve of 3% of these items. In making these determinations of allowances for accessory income (if any), the allowance shall not exceed the Cooperative's estimate or the appraiser's estimate of accessory income, whichever is the lesser. However, rental payables under duly executed acceptable leases for commercial space on the premises shall be used in lieu of estimates. These payables should be totaled to be sure all members have assurance that the total membership has their required minimum equity requirements. The HUD-FHA estimate of annual charges will include the following:

- Debt Service (Mortgage amount x percent of debt service).

- Cooperative Operating Expenses, Reserve for Replacements, Taxes, Special Assessments and Ground Rent, if any.

- (Memorandum attached to form HUD-92264). General Operating Reserve of 3% of Sum of Above.

f. Review of the Cooperative's Procedure for Approving New Members. The procedures employed by the Cooperative in approving new members (cooperators) should be reviewed to ascertain if there is compliance with any income requirements and credit scores as contained in the Cooperative's bylaws or other related agreements. Individual files for anyone becoming a member in the three month period immediately prior to the date the application for Firm Commitment was submitted must also be reviewed by the HUD processing office.

g. Maintenance Charges. In reference to I.E.9 and I.E.10, the HUD processing office must review the procedures employed by the Cooperative in reviewing its budget, determining the adequacy of the carrying charge and to its history of carrying charge increases. In reference to I.E.9, the Cooperative's Bylaws or other appropriate organizational documents must contain a provision that requires an annual increase in the carrying charge based on inflation, in order to address increases in operating expenses.

The total amount of the unpaid balance (30 days or more) for carrying charges and special assessments as shown in the rent roll (see I.D.1) must not exceed 5% of the gross annual income.

2. Determination of Total Debt Service, Cooperative Operating Expense and GOR. Total Debt Service will be calculated by multiplying the amount of the mortgage by the sum of initial curtail rate, interest rate and MIP. Cooperative Operating Expense includes those operating expenses, reserve for replacements, taxes, special assessments and ground rents, if any, which are the responsibility of the Cooperative membership as a whole rather than of the individual members. These expenses will include the cost of occupancy of the units assigned to employee use. The GOR is 3% of the sum of the annual charges described above, and is accumulated as a special reserve in order to meet possible contingencies.

3. Outstanding Debt. Past due accounts payable and outstanding project liabilities must be cleared and released, or otherwise fully satisfied, prior to or at loan closing. Examples of such items include deferred management fees, overdue utility bills or real estate taxes, or trade payables. These items are not to be included in the eligible debt basis.

4. Completion of the form HUD-92264-A and Determining the Maximum Insurable Mortgage. Pages 1-2 of the form HUD-92264-A shall be completed according to existing instructions, modified as noted in Section I.A.

E. Asset Management Processing. The application must include, and the processing office must review the applicants' management plan, including training requirements, and a description of maintenance procedures and management of the Reserve for Replacement funding and work items.

III. Issuance of Firm Commitment and Loan Closing. Follow existing procedures for Section 223(f), FHA Required Closing Instruments, FHA Form No. 3257-B, also set out in Handbook 4550.3, Appendix 3-10, and the HUD Closing Handbook, as applicable.

IV. Environmental Impact. A Finding of No Significant Impact with respect to the environment has been made in accordance with HUD regulations at 24 CFR part 50, which implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)).

V. Paperwork Reduction Act. The information collection requirements contained in this document have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) and assigned OMB control number 2502-0029. In accordance with the Paperwork Reduction Act, HUD may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a currently valid OMB control number.

Any questions regarding this ML should be directed to Joseph Sealey, Director of the Technical Support at (202) 402-2559. 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