



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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

December 29, 2011

MORTGAGEE LETTER 2011-40

TO: All Mortgagees
All Multifamily Hub Directors
All Program Center Directors
All Project Managers
All Field Office Directors

SUBJECT: Large Loan Risk Mitigation Policies

I. Purpose

This Mortgagee Letter supplements risk management guidance set forth in Notice H 2010-11, Mortgagee Letter 2010-21 and Notice H 2010-13. The intent of this Mortgagee Letter is to address the increased risks to the insurance fund presented by loans above \$25 million (M) in size and/or which support projects in excess of 150 housing units, or by loans and projects sized at certain higher thresholds, depending on the insurance program. This Mortgagee Letter spells out underwriting standards that will be applicable to such loans in regards to Debt Service Coverage Ratio (DSCR), Loan to Cost Ratio (LTCR), Loan to Value Ratio (LTVR), funding for Initial Operating Deficit (IOD) and Debt Service Reserve (DSR), in addition to other underwriting and credit requirements for such loans.

The new standards contained in this Mortgagee Letter will not apply to: a) loans below these size/unit thresholds, b) refinancing loans processed under Section 223(a)(7), c) refinancing or substantial rehabilitation loans for properties with rental assistance contracts covering 90% or more of the property's units, or d) the insurance programs administered by the Office of Healthcare Programs.

II. Background

The capital markets for multifamily financing, while improving, still face significant challenges. In the context of these continuing challenges, FHA is being asked to insure more loans with sizes much greater than historically experienced by the Department. The insurance fund can suffer an extraordinary loss from 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. While overall program standards were tightened with the issuance of Notice H 2010-11 and Mortgagee Letter 2010-21, those changes only imposed higher minimum underwriting standards and reserve floors, but did not adjust the standards for loan size or project size.

This Mortgagee Letter provides specialized underwriting policies designed to mitigate the increased risks to the insurance fund of large loans. The policies are intended to protect the insurance fund while not placing an excessive burden on large projects or overly limiting those that will qualify for an insured loan. Large loans will continue to enjoy the benefits of FHA's lending terms and permitted leverage. The large loan thresholds established in this Mortgagee Letter are higher than those of other capital sources because all insured loans are fixed rate, long-term, fully amortizing loans.

III. **Underwriting and Reserve Standards for Large Loans**

A. The following DSCR, LTVR and LTCR underwriting standards shall be applied incrementally as loan sizes increase, as shown below:

New Construction/Sub Rehab under Sections 220, 221(d)(3), 221 (d)(4) and 231 on loans at or above \$40M:

Loan size	Affordable/ mixed income DSC limits	Affordable/ mixed income LTC limits	Market DSC limits	Market LTC limits
<\$40M*	1.15*	87%*	1.20*	83.3%*
\$40M – \$60M	1.20	85%	1.25	80%
>\$60M	1.25	80%	1.30	75%

*Represents current underwriting guidance.

Refinancing under Section 223(f) on loans at or above \$50M:

Loan size	Affordable/ mixed income DSC limits	Affordable/ mixed income LTV limits without or with cash out	Market DSC limits	Market LTV limits without or with cash out
<\$50M*	1.176*	85%*/80%*	1.20*	83.3%*/ 80%*
\$50M – \$75M	1.20	83.3%/75%	1.25	80%/75%
>\$75M	1.25	80%/70%	1.30	75%/70%

*Represents current underwriting guidance.

For new construction/substantial rehabilitation or refinancing loans over \$100M, the lender should use the >\$60M or >\$75M underwriting standards, above, applicable to the program. Within 5 business days after the required concept meeting, the HUD staff will advise the lender as to whether the standards described here or higher standards will apply. Based on HUD's analysis of the risks and the mitigants appropriate to the

particular loan application, the required minimum DSCR, LTCR and LTVRs for loans at or above \$100M may be increased.

B. Increased IOD Reserves on Sections 220, 221(d)(3), 221 (d)(4) and 231 Loans at or above \$25M or by Unit Count

Minimum IOD reserves for loans at or above \$25M or 150 units (whichever is the lower controlling criteria) on projects supported by Sections 220, 221(d)(3), 221 (d)(4) and 231 loans are as follows:

Loan size/unit count	The minimum IOD reserve will be the greater of the amount calculated in column A or column B or the amount determined under Section 7.14 of the MAP Guide, <i>Calculating Operating Deficits</i> .	
	Column A	Column B
	Minimum number of months of debt service	Minimum % of the mortgage amount
<\$25M* <150 units	4 - 6 months debt service*	3.00% of mortgage*
\$25M – \$40M 150 – 250 units	9 months debt service	4.50% of mortgage/
>\$40M –\$60M 251 - 400 units	12 months debt service	6.25% of mortgage
>\$60M > 401 units	15 months debt service	8.00% of mortgage
	Note: for projects \$25M or more or 150 or more units which will complete rent-up within 12 months of construction completion, the stated minimum number of months of debt service may be reduced by 3 months.	Note: for projects \$25M or more or 150 or more units which will complete rent-up within 12 months of construction completion, the stated minimum % of the mortgage amount may be reduced by 1.5%.

*Represents current underwriting guidance

For new construction/substantial rehabilitation loans over \$75M or 500 units (whichever is the lower controlling criteria), lenders should use the >\$60M/401 unit IOD reserve requirements when underwriting the loan. Within 5 business days of the required concept meeting, the HUD staff will advise the lender as to whether those IOD reserve requirements or higher reserves will apply, based on HUD's analysis of the risks and the mitigants appropriate to the particular loan application.

C. Increased Debt Service Reserves on Section 223(f) Loans on Newly Stabilized Properties at or above \$25M or by Unit Count

For properties with loans at or above \$25M or 150 units (whichever is the lower controlling criteria) that apply for a Section 223(f) refinancing loan under the 3-year rule waiver before the waiver expires in February 2012, and that have recently stabilized (i.e. have reached a

minimum 85% occupancy for 90 days prior to endorsement), a funded debt service reserve is required, as follows:

Loan size/unit count	Debt service reserve
<\$25M* <150 units	4 months debt service*
\$25M – \$40M 150 – 250 units	6 months debt service
>\$40M >251 units	9 months debt service

*Represents current underwriting guidance.

In addition, for any Section 223(f) loans (processed with or without the 3-year rule waiver) over \$75M or 500 units (whichever is the lower controlling criteria), a funded debt service reserve in an amount as determined by HUD during application processing may be required based on HUD's analysis of the risks and the mitigants appropriate to the particular loan application.

D. Other Underwriting Requirements for Large Loans over \$25M

The following underwriting and mortgage credit requirements will apply to all large loans at or above \$25M under any of the rental housing insurance programs:

i. Principal's net worth and liquidity requirements

Principals of the borrowing entity must have, in aggregate, net worth equal to at least 20% of the loan amount and liquidity equal to at least 7.5% of the loan amount. This requirement may be waived for sponsors of subsidized affordable housing properties.

ii. Recognition of land or building value appreciation

For properties refinanced under Section 223(f), or for land or buildings contributed for development under Sections 220, 221(d)(3), 221 (d)(4) and 231, the HUD review appraiser may not recognize an increase in the appraised value above the borrower's acquisition cost plus the direct costs incurred for property improvements, unless the borrower has owned the property for 3 years or longer as of the date of application. For properties owned for less than 3 years as of the date of application, the recognized value of the property will be the lower of: a) the appraised value, or b) the property acquisition cost plus direct costs incurred by the borrower for improvements to enhance or upgrade the property, such as to rehabilitate or upgrade an existing building, to obtain a zoning change, or for improvements to land such as removal of environmental hazards or

improvements to infrastructure, which costs and improvements must be documented by the borrower and verified by the lender.

For properties owned for less than 3 years as of the date of application, the Hub Director may issue a waiver to permit recognition of an increase in the appraised value above the property acquisition cost plus the cost of improvements, only if both of the following criteria are met:

a) The values of comparable properties located in the subject's submarket have also increased since the date of acquisition, and

b) The value increase is based on an increase in property NOI due to improved property operations and is not based solely on recognition of a capitalization rate that is lower than what was prevalent in the market or was applied by the sponsor at the time the property was acquired.

iii. Experience requirements

Large loan borrowers must have substantial prior experience developing, constructing and owning multifamily projects that are similar in size and scope to what is proposed. Borrowers or contractors without substantial prior experience in multifamily construction lease up and property operations, and who have not previously successfully owned or developed other large multifamily projects, will not qualify for a large loan under any of the insurance programs. Related experience in single family development or in development of commercial properties is not an acceptable substitute for the required prior multifamily experience and may not be a basis for a waiver of the experience requirement.

iv. Delayed release of cash out on loans under Sections 220, 221(d)(3), 221(d)(4) and 231

The release of any cash out proceeds for the excess value of the property contributed for a new construction or substantial rehabilitation development must not occur until the completed project has operated at breakeven occupancy for 12 consecutive months. Release of such proceeds will otherwise be in accordance with applicable MAP Guide requirements.

IV. Implementation

The provisions contained in Part III B and C, above, of this Mortgagee Letter are effective immediately upon issuance and shall apply to all loan applications under Sections 220, 221(d)(3), 221(d)(4), 231 and 223(f) (3 year rule waiver) for which an Invitation Letter has not yet been issued or, in the case of single-stage processed loans, a Firm Commitment has

not yet been issued.

The provisions contained in Part III A and D, above, of this Mortgagee Letter shall apply to all loan applications under Sections 220, 221(d)(3), 221 (d)(4), 231 and 223(f) for which an Invitation Letter has not yet been issued or, in the case of single-stage processed loans, a Firm Commitment has not yet been issued. In cases where such an application was submitted before January 1, 2012, the Hub Director has authority subject to existing delegations and loan approval limits to waive these provisions if appropriate. Lenders with large loan applications pending that have not yet received an Invitation Letter or Firm Commitment may withdraw the application and request a refund of the application fee in accordance with current departmental policies.

If there are any questions regarding this Mortgagee Letter, please contact Daniel Sullivan, at (202) 402-6130, Headquarters Office of Multifamily Development. Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-800-877-8339.

/s/

Carol J. Galante
Acting Assistant Secretary for Housing –
Federal Housing Commissioner