



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

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

September 4, 2014

MORTGAGEE LETTER 2014-18

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

SUBJECT: Revisions to Large Loan Risk Mitigation Policies

I. **Purpose**

This Mortgagee Letter supersedes HUD's underwriting standards for large multifamily loans (Mortgagee Letter 2011-40 and Mortgagee Letter 2014-04), above \$25 million and/or which support projects exceeding unit thresholds.

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

II. **Background**

Mortgagee Letter 2011-40 and Mortgagee Letter 2014-04 discussed the need for specialized underwriting standards to mitigate the increased risks to the insurance fund of losses from Large Loans on properties located in a single submarket with potentially hundreds of rental units. The revisions incorporated in this subsequent Mortgagee Letter are intended to provide greater clarity and thus enhanced understanding of the requirements on the part of both industry and HUD staff.

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

A. The following Debt-Service Coverage Ratio (DSCR), Loan-to-Value Ratio (LTVR), and Loan-to-Cost Ratio (LTCR) underwriting standards shall be applied incrementally as loan sizes increase:

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

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

\*Represents current underwriting guidance. “Affordable housing” is defined in Mortgagee Letter 2010-21, and the Multifamily Accelerated Processing (MAP) Guide, Section 3.2.Q.

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

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

\*Represents current underwriting guidance.

For New Construction/Substantial Rehabilitation or refinancing loans over \$100M, the lender should use the >\$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, LTV or LTVRs for loans over \$100M may be increased.

**B. Minimum Initial Operating Deficit (IOD) and Debt Service Reserves for Large Loans.**

New Construction/Substantial Rehabilitation projects should have a minimum amount of Initial Operating Deficit Reserve to help assure success of these projects during their early, most vulnerable stages of rent-up. Because newly completed projects financed with Section 223(f) under a 3-year rule waiver may face similar rent-up challenges, a minimum Debt Service Reserve is likewise required for those Large Loans as well.

The following minimum Reserve amounts apply to Sections 220, 221(d)(4) and 231 Loans (as IOD's) and Section 223(f) Loans (as Debt Service Reserves for 3 year rule waiver Newly Completed Properties). If the amount determined under Section 7.14 of the MAP Guide "Calculating Operating Deficits" exceeds the amount shown below, the MAP Guide amount takes precedence.

	Loan size /unit count*	Reserve amount based on minimum number of months of <u>amortizing</u> debt service, including MIP
1.	<\$25M or ≤ 250 units	Between 4 to 6 months debt service**
2.	≥\$25M and ≥251 but less than the criteria for No. 3 and No. 4	9 months debt service
3.	>\$75M and >400 units	12 months debt service
4.	>\$100M	12 months debt service, unless a higher amount is identified through HUD analysis of the risks and the mitigants appropriate to the particular loan application
		Note: for projects \$25M or more and 250 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.

**\*Examples:**

- (1) \$20M loan for a 500 unit project requires an IOD of 4 to 6 months of debt service.
- (2) \$80M loan for a 300 unit project requires a minimum IOD of 9 months of debt service.
- (3) \$80M loan for a 450 unit project requires a minimum IOD of 12 months of debt service.
- (4) \$30M loan for a 220 unit project requires an IOD of 4 to 6 months of debt service.

**\*\*Current underwriting guidance for non-Large Loans.**

For new construction/substantial rehabilitation loans over \$100M, lenders should use the >\$75M/>400 unit minimum IOD amount above when underwriting the loan. Within 5 business days of the required concept meeting, the HUD staff will advise the lender as to whether the IOD amount is sufficient or a higher amount will be required, based on HUD's analysis of the risks and the mitigants appropriate to the particular loan application.

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 recommended by the lender 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.

Release of Initial Operating Deficit or Debt Service Reserve amounts will be in accordance with the MAP Guide or other applicable directive.

#### C. 18 month Maximum Absorption Period.

The provision, stated in Mortgagee Letter 2010-21 on Risk Mitigation, which limits the absorption period for estimating market demand to 18 months, continues to apply to all projects including those with loans exceeding both \$25M and units above 250. Hub Directors may waive the 18-month absorption period restriction only in cases where there is an unusually strong market which will support initial rent-up to sustaining occupancy beyond 18 months and where the borrower has clearly demonstrated successful experience with developing such projects in the recent past. Such projects may require larger Initial Operating Deficit or Debt Service Reserves than the minimum amounts calculated in accordance with paragraph III, B above.

#### D. Other Underwriting Requirements for Large Loans.

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 percent of the loan amount and liquidity equal to at least 7.5 percent 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)(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 for large new construction or substantial rehabilitation projects.

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)(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 this Mortgagee Letter are effective immediately upon issuance and shall apply to all appropriate loan applications under Sections 220, 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.

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.

If you have any questions, and/or concerns regarding this Mortgagee Letter, please contact Theodore K. Toon at (202) 402-8386, Headquarters Office of Multifamily Housing Development. Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-800-877-8339.

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