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

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OFFICE OF HOUSING

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Dear Mr. Niles:

Thank you for your September 14, 2010 letter and your attendance at the recent meeting held to discuss the use of reserve for replacement accounts ("Replacement Reserves") and related issues associated with Mark-to-Market ("M2M") rent and debt restructured properties.

There has been substantial discussion about the inappropriate use of operating income to cover expenses that should have been paid from Replacement Reserves and an owner's right to receive M2M Incentive Performance Fees ("IPF(s)"). Notwithstanding (a) the collaborative M2M underwriting process , and (b) written guidance to owners, project accountants and M2M stakeholders from the Office of Affordable Housing Preservation ("OAHP") since 2004, some owners and their representatives continue to express confusion with respect to their responsibilities under the M2M HUD-held cash-flow second mortgage loans called Mortgage Restructuring Mortgages ("MRM(s)") and the notes that evidence an MRM indebtedness (the "MRN(s)"). This confusion may stem from a failure by program participants to recognize fully the legal impact of the Multifamily Assisted Housing Reform and Affordability Act of 1997, as amended ("MAHRA"), on the rights and obligations of owners of these properties.

Whatever the source of the confusion, I want to reassure you that OAHP and the Office of Multifamily Housing Programs are committed to work together in an effort to achieve a more seamless application of these matters. We plan to issue additional Replacement Reserves guidance in the near future. In the interim, HUD field offices will generally allow the reimbursement from Replacement Reserves to operating accounts of those sums which OAHP has determined should have been drawn from the Replacement Reserves in the first instance. Upon request for reconsideration submitted to OAHP by an owner, OAHP will review the outstanding demands that have been made to owners for the return of IPFs associated with (a) the use of funds from operating accounts instead of the Replacement Reserves, and (b) late payments made by owners on an MRN, and will provide relief when an owner clearly appears to have acted in good faith, but in a manner inconsistent with the requirements of the MAHRA program. In some instances, however, when an owner has taken an IPF but the conditions to do so set forth in the M2M regulatory agreements were clearly not satisfied prior thereto, an appropriate demand for the return of the IPF will be made. Examples might include the following: an owner's financial report shows surplus cash, from which the payment due on the MRN was not made prior to the taking of the IPF, or the property received less than a 60 rating for the year from HUD's Real Estate Assessment Center.

In your letter you state that HUD's Asset Management Handbook 4350.1 REV-1 ("Handbook") "has long instructed project owners that capital needs may be funded from operating cash flow, as well as other sources, because the Replacement Reserve 'will not always be adequate to meet the future capital needs of a project nor is it expected to do so.'" You also cite additional provisions, including a reference to Replacement Reserves as a source to help defray the costs of replacing a project's capital items, and the statement that "'[j]udicious use of the [Replacement Reserve] is expected to extend the physical life of their projects.'"

It is important to understand that this Handbook provides instructions on the general requirements that owners must follow in managing HUD-insured multifamily projects. As the provisions you cite suggest, the need to look outside the Replacement Reserves for the funding of capital replacement projects is often the result of the inadequacy of those Reserve accounts in many non-MAHRA projects. When the debt on a property has been restructured under MAHRA, however, special requirements govern this question, arising from the restructuring of the debt and the rents that will support the new debt on the property.

Specifically, MAHRA provides that, "Each mortgage restructuring and rental assistance sufficiency plan shall . . . require the owner or purchaser of the project to take such actions as may be necessary to rehabilitate, maintain adequate reserves, and maintain the project in decent and safe condition, based on housing quality standards established by ... the Secretary..." (underlining provided). See MAHRA section 514 (e)(5). HUD has, through its regulations, implemented this provision by requiring the owner to establish a Replacement Reserves account and a plan for replenishing that account that will be sufficient to maintain the property in decent and safe condition over at least the term of any project-based assistance contract on the property. No wording contained in either this section of the statute or the implementing regulations contemplates the use of project operating income to fund any major replacements needed for this purpose.

The implementing regulations further support this intentional difference between the approach of establishing and utilizing Replacement Reserves in MAHRA projects and the approach followed for a multifamily project where the mortgage has not been the subject of a restructuring under MAHRA. Under the regulations, an owner and HUD (with the assistance of a Participating Administrative Entity or "PAE") are charged with evaluating the physical condition of a property undergoing a rent and debt restructuring (the "Restructuring") and then determining (i) the capital repair or replacement items that will be necessary to maintain the long-term physical integrity of the property, and (ii) an estimate of the initial deposit, together with the estimated monthly deposits needed, for the next 20 years. (See 24 CFR 401.450, 451 and 453). After these determinations are completed, the owner receives from the PAE a term sheet that includes, among other funds to be generated and used through the Restructuring, the amount of funding which may be added to other project accounts to establish the Replacement Reserves. The funding that becomes the opening amount of the Replacement Reserves is called the "initial deposit to the replacement reserves" (or "IDRR"). Once approved by the owner, the IDRR becomes one of the terms and conditions of the M2M Restructuring Commitment (the "RC"), which is the contractual agreement between HUD and an owner that contains the terms and conditions for a Restructuring. By its terms, the RC continues to bind HUD and the owner after the closing of the Restructuring.

Establishing the initial Replacement Reserves account and the amount of monthly contributions to the Replacement Reserves from project operating income in amounts sufficient to maintain the long-term physical integrity of the property is a critical component of the underwriting for the Restructuring. At the time of the Restructuring, the primary source of funding of the Replacement Reserves is the payment of a claim from HUD's General Insurance Fund, which contributes significantly to the amount ultimately determined to be the original principal balance of the Mortgage Restructuring Mortgage. The original principal amount of the Mortgage Restructuring Mortgage, however, is limited by MAHRA and a corresponding regulation to "the amount that the PAE reasonably expects to be repaid based on objective criteria <u>such as the amount of anticipated net cash flow</u>, trending assumptions, amortizations provisions, and expected residual value of the property." (emphasis added; see 517(a)(1)(B)(ii) and 24 CFR 401.461(a)(2)(i)) Pursuant to MAHRA and the corresponding regulation, the owner and HUD must determine (and trend forward) the anticipated reasonable and necessary operating expenses for a property (including monthly contributions to the Replacement Reserves), in order to enable the PAE to project the amount of "net cash flow" that will be available to service the Mortgage Restructuring Mortgage during its term. (see MAHRA section 517(a)(3)) and the corresponding regulation 24 CFR 401.461(b)(3)(i) and (b)(3)(i)) Once this amount is calculated, HUD is then able to determine the amount for or "size" the Mortgage Restructuring Mortgage, which is statutorily constrained to an amount that "can reasonably be expected to be repaid."

Consequently, we think it is clear that in those cases where a multifamily mortgage has been restructured under MAHRA, the use of operating income is restricted and the Replacement Reserves must be the first source of funding to pay for capital repairs or replacement items. [1] While we think the statute and regulations are sufficient and speak for themselves, we are providing the following explanations to supplement our conclusions.

The M2M handbook, known as the Operating Procedures Guide ("OPG"), provides substantial direction to the PAEs on how to analyze operating expenses using historical expenses from the property's audited financial statements and work collaboratively with the owners to determine the 20-year repair, maintenance and replacement needs. The results of this collaborative effort are directly incorporated into the term sheets sent to owners, and then become critical terms and conditions of each RC. To subsequently ignore this process and enable owners to unilaterally elect to use operating income instead of Replacement Reserves would frustrate the critical elements and the integrity of M2M.

Other documents that evidence or secure the MRM or that are otherwise executed as part of a Restructuring provide additional support regarding the use of operating income and Replacement Reserves. The riders to the regulatory agreements add to the traditional language contained in regulatory agreements prepared for Section 8 assisted properties and affirmatively state that the Replacement Reserves are "to **cover** the cost of major replacements that are for the purpose of effecting replacement of structural elements and mechanical equipment of the Project or for any

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[1] The underwriting process to determine the IDRR is a sophisticated analysis that not only involves inflationary adjustments, but includes calculations to average the needs for the entire 20 year period, calculations to determine the average needs for each five year period, and a final determination to provide the property with a sufficient ending balance in year 20 to cover major systems that may then be at the end of their useful life.

other purpose approved by HUD." (Emphasis added; see section 1 of the regulatory agreement rider for the M2M FHA first mortgage loans, or section 3 of the regulatory agreement rider for the MRMs.) In this context, *Webster's* defines "cover" to mean "to deal with."

The definition of "Surplus Cash" in each mortgage note (a "Mortgage Restructuring Note" or "MRN") that evidences an MRM provides additional support for HUD's position that the use of operating income is restricted and the Replacement Reserves must be the first source of funding to pay for capital repairs or replacement items. In subsection 2.e. of each MRN, Surplus Cash is defined as "any cash remaining at the end of each Payment Period after:

> **(1)** the payment of: **(i)** All sums due or currently required to be paid under the terms of (a) the [first mortgage] Loan if any, the lien for which is prior to the lien of the Mortgage Restructuring Mortgage securing this Mortgage Restructuring Note, and, (b) if applicable, subordinate FHA insured or HUD held mortgages with cash flow priority ("Priority Cash Flow Indebtedness") to this Mortgage Restructuring Note; **(ii)** all amounts required to be deposited in the reserve fund for replacements; **(iii) all other obligations of the Mortgaged Property other than the Loan and Priority Cash Flow Indebtedness, unless funds for payment are set aside** or deferment of payment has been approved by the Secretary, and (iv) the Capital Recovery Payments, if any; and . . ." (emphasis added)

Among the items that are subtracted from operating income to determine the Surplus Cash, the MRN allows the deduction from operating income of the sums needed to make the monthly contribution to the Replacement Reserves and then of the payment of "all other obligations of the Mortgaged Property . . . unless funds for payment are set aside or deferment of payment has been approved by the Secretary . . ." Thus, the cost of major replacements of structural elements and mechanical equipment may not be considered as comprising "all other obligations of the Mortgaged Property," because funds have been set aside (i.e. the Replacement Reserves) for such purposes. Further, Surplus Cash is not derived until after additional contributions to the Replacement Reserves have been made, all of which is intended to cover the costs of these items without resorting to the use of operating income to cover such costs.

The foregoing demonstrates an active and deliberate process that was created when the provisions of MAHRA were implemented to determine the amounts of initial and ongoing funding for and directed use of the Replacement Reserves. If there is an unexpected event or a previously approved item is found to cost more than anticipated at the time of the underwriting for the Restructuring, however, and if either HUD or an owner is concerned about the amount that will remain in the Replacement Reserves due to such expenditure, HUD may approve the owner's request to use operating income or to increase its monthly contributions to the Replacement Reserves.

We look forward to working together with HUD's program participants in servicing the MRNs in compliance with the requirements contained under MAHRA, recognizing the impact of MAHRA on these very important affordable housing properties.

Sincerely,

Carol Galante

Carol J. Galante
Deputy Assistant Secretary
for Multifamily Housing Programs