
Chapter 14.

PARTIAL PAYMENT OF CLAIMS, RESTRUCTURING OF HUD-HELD LOANS, AND MODIFICATIONS OF FHA-INSURED LOANS

Section 1. GENERAL INFORMATION

14-1. INTRODUCTION

Chapter 14 provides guidance regarding three types of FHA workout related multifamily transactions: Partial Payments of Claims (“PPCs”), restructuring of HUD-Held Loans (“Restructuring”), and modifications of FHA-insured loans to accommodate refinancing (“Modifications”). This introduction (Section 1) provides brief descriptions of each type of transaction as well as specifics of the types of FHA-Insured loans eligible and ineligible for all of these transactions. Sections 2, 3, and 4 describe the particular characteristics of PPCs, Restructuring and Modifications, respectively. Sections 5 through 7 are applicable to all three types of transactions: Section 5 describes the application, review, approval and appeals process, while Sections 6 and 7 address closing and post-closing requirements, respectively.

Partial Payment of Claim. This approach is used to avert a full claim when an FHA-insured, loan generally involving a market-rate multifamily project goes into default due to circumstances determined to be beyond the Owner’s¹ control. A PPC results in a claim against the FHA General Insurance Fund, but it may be warranted by the need to preserve housing that may be affordable although it is generally not subsidized. Furthermore, the claim amount is retained and recovered through a second mortgage, and the attendant reduction in the project’s first mortgage principal balance enables FHA to help to stabilize the project for the long term. Thus, potential benefits of PPCs include preserving or providing affordable housing, stabilizing project operations, curing an existing default, and maximizing longer term returns to the FHA General Insurance Fund.

In order to avoid a full insurance claim and assignment of the mortgage to FHA, FHA pays mortgage insurance benefits to the mortgagee for a portion of the principal balance (“PPC Claim”) and recasts the remaining principal balance of the mortgage under terms and conditions determined by HUD. In order for HUD to offer a PPC, the mortgagee and the Owner must first voluntarily agree to accept the terms for a partial payment of the insurance claim in accordance with the terms detailed in this Chapter. The mortgagee must also waive any prepayment and lockout provisions in the mortgage. The requirements of Mortgagee Letter 87-9, pertaining to prepayment and lockout provisions for bond-financed projects, are met by following the requirements of this Chapter. The Mortgagee Letter is attached as Appendix A.

On the same date that the PPC is completed, the Owner enters into a second HUD obligation, the “PPC Note and Mortgage”, in the amount of the PPC claim plus overdue interest on the

¹ HUD uses Owner as a single reference to include but not be limited to principal, mortgagor and mortgagor entity. It may also refer to the controlling individual in an Ownership entity, for example, a managing member or general partner.

mortgage, obligating the Owner to pay 75 percent of the project's annual surplus cash flow as repayment. The Owner will also enter into a 20 year HUD Use Agreement (see 14-6.C. and 14-9.C.). Finally, HUD will waive the deduction of one percent of the mortgage funds advanced to the mortgagor, provided for in 24 CFR 207.259(b)(2)(iv), with respect to a PPC. (See 24 CFR 207.258b(d)).

Restructuring. The second type of transaction addressed in this Chapter is the restructuring of HUD-held notes. These notes are formerly FHA-insured first mortgages that have been acquired by HUD in the course of an assignment for full insurance benefits. Restructurings require: 1) a new insured or uninsured first mortgage that pays down the HUD-Held note and 2) recasting of the remaining principal balance of the HUD-Held Note into a new "Restructuring Note and Mortgage". The Restructuring Note is subordinated to the new first mortgage, and paid with 75% of surplus cash. To the extent that the new first mortgage has a lower principal balance and/or provides better terms than the old, the project's operations will benefit and this will help to stabilize and preserve the housing.

Modification. The final type of transaction addressed in this Chapter is a modification of a defaulted FHA-insured mortgage ("Modification"). (Note that modifications of FHA-insured multifamily loans that are not in default and that have no lockout or prepayment restriction are handled by Multifamily Asset Management under other guidance and regulations.) Through this approach an FHA-insured loan may be adjusted to stabilize the project. A Modification may involve a change in interest rate, as well as an extension of the term of the loan in some cases, resulting in adjusted payments and a new amortization schedule. It will not result in a claim on the FHA General Insurance Fund however. If the loan was bond financed, the lockout and/or prepayment prohibitions will be addressed as described in Mortgagee Letter 87-9. A Modification is designed to achieve several of the same benefits that can be obtained through a PPC: Preserving or providing affordable housing, stabilizing project operations, and maximizing longer term returns to the FHA General Insurance Fund.

The process for requesting, reviewing, approving and closing PPCs, Restructurings or Modifications will be similar except for parts of the closing activity. Owners of projects in danger of defaulting should be in discussions with their projects' HUD Project Managers early on, and must provide Monthly Accounting Reports ("MARs") every month well in advance of and throughout the processing of a request. However the formal process begins when an Applicant (hereinafter defined) submits a request to HUD (the "Application"²) signed by its legally authorized agent. Typically, Applications are prepared and submitted by the mortgagee, although the Owner must concur with the Application and execute certain documents, so the term "Applicant" is used below with reference to both parties.

Once the Hub/Program Center (or "Hub/PC")³ obtains a complete Application and undertakes the brief threshold review described in Section 14-14, below, the Application is transmitted to the Office of Affordable Housing Preservation (OAHP) at Headquarters. OAHP then completes

² With respect to a Partial Payment of Claim, the term Application shall mean the documentation submitted by a Lender or Borrower to support a request for HUD to consider whether or not to offer a PPC to the Lender.

³ The term "Hub/PC" refers to the initial HUD entry point for an Owner's request for any of the transactions described in this Chapter. If the project is overseen by a Multifamily Program Center it will be submitted to the Program Center. Alternatively if there is no Multifamily Program Center for the project's area, the request will be handled directly by Hub staff. For approvals, both the Program Center (if any) and the Hub Directors are to be involved.

a detailed analysis, prepares a recommendation and approves or rejects the Application in conjunction with the Hub/Program Center Director(s) and Project Managers overseeing the project, and with Asset Management, also at Headquarters. Finally, it is important to note that all three of these forms of workouts will require a 20-year Use Agreement (see 14-6.C., 14-9.C., and 14-12.B.).

14-2. MORTGAGES ELIGIBLE UNDER THIS CHAPTER⁴

Section 207: Multifamily Housing Mortgage Insurance;

Section 213: Cooperative Housing Mortgage Insurance;

Section 220: Mortgage Insurance for Urban Renewal;

Section 221(d): Low-cost and moderate-income mortgage insurance-except for coinsured or formerly coinsured;

Section 223(f): Except for coinsured or formerly coinsured; and

Section 542(c): HFA Risk Share.

NOTES:

In the case of Restructurings, HUD-Held notes originated under any of the FHA programs listed above are eligible.

Section 236 notes are eligible for a Modification but not for a PPC or Restructuring.

Projects reinsured under Section 223(a)(7) are only eligible if the original mortgage (before reinsurance) was insured under one of the programs above.

Mortgages must have completed final endorsement before a PPC, Restructuring or Modification will be considered.

14-3. MORTGAGES INELIGIBLE UNDER THIS CHAPTER

Section 203: Single Family Mortgage Insurance;

Section 257: Hope For Home Owners Program;

Section 234: Condominium Ownership Mortgage Insurance;

Section 232: Health Care;

⁴ All "Section..." references in Parts 14-2. and 14-3. refer to the National Housing Act, as amended from time to time. All "Part..." references in Parts 14-2. and 14-3. refer to 24 CFR.

Section 236: Mortgage Insurance and Interest Reduction Payment for Rental Projects (Note: Section 236 notes are ineligible for a PPC or Restructuring, but eligible for a Modification);

Section 242: Hospitals;

Part 244: Group Practice Facilities;

Part 251: Coinsurance for the Construction or Substantial Rehabilitation of Multifamily Housing Projects;

Part 255: Coinsurance for the Purchase or Refinancing of Existing Multifamily Housing Projects (i.e., projects coinsured under 223(f)); and

Formerly coinsured mortgages that have been converted to full insurance under Section 207 of the National Housing Act including Section 221(d) of the National Housing Act.

NOTE: The Office of Multifamily Housing has elected not to exercise the authority under Section 541 of the National Housing Act to process PPCs with respect to the types of multifamily projects listed in this Section and lacks authority to process PPCs for hospitals, group homes or health care facilities. PPCs for hospitals, nursing homes, assisted living facilities, intermediate care facilities, or board and care facilities are processed by the Office of Healthcare Programs.

Section 2. PARTIAL PAYMENT OF CLAIM

PPCs are used to avoid a full insurance claim against the FHA General Insurance Fund when an FHA-insured mortgage on a multifamily project goes into default due to circumstances determined to be beyond the Owner's control. It results in a smaller claim but this may be warranted by the need to preserve housing that may be affordable, and may or may not be subsidized. A PPC is considered a "last resort" primarily to avoid a full insurance claim, and it is approved only after all other financial resources available to the project have been exhausted. The Owner must demonstrate that conditions contributing to the default that are within the Owner's control have been resolved, that project operations and occupancy are stabilized, and that a PPC is likely to result in long term stability of the project.

Through the PPC process, HUD pays to the mortgagee a portion of the outstanding principal balance of the first mortgage, the PPC Claim amount. HUD simultaneously recasts the remaining first mortgage principal balance into a new first mortgage obligation. A new second mortgage obligation, the "PPC Note and Mortgage" (in the amount of the PPC Claim plus overdue interest on the old first mortgage) is also created in the transaction. The PPC Note obligates the Owner to pay 75% of the project's annual surplus cash as repayment, and to enter into a 20-year HUD Use Agreement (see 14-6.C., 14-9.C., and 14-12.B.). In order for HUD to offer a PPC, the mortgagee and the Owner must first voluntarily agree to accept the terms for a partial payment of the insurance claim detailed in this Chapter, with the knowledge that any prepayment and lockout provisions in the mortgage are waived. The requirements of Mortgagee Letter 87-9 are met by following the requirements of this Chapter.

14-4. APPLICABLE REGULATIONS

The applicable regulation for PPCs is 24 CFR 207.258b, titled: "Partial payment of claim." Accordingly, prior to the approval of a PPC, the Federal Housing Administration (FHA) Commissioner must, at a minimum, make the following findings:

- A. The mortgagee is entitled, after a default under 24 CFR 207.255, to assign the mortgage in exchange for the payment of insurance benefits;
- B. The relief resulting from partial payment, when considered with other resources available to the project, would be sufficient to restore the financial viability of the project;
- C. The project is or can, at reasonable cost, be made structurally sound;
- D. The management of the project is satisfactory to the FHA Commissioner, as demonstrated by a rating of at least "Satisfactory" on the most recent management review;
- E. The default under the insured mortgage was beyond the control of the Owner;
- F. The project is serving, or potentially could serve as a low and moderate-income housing resource;

-
- G. The property covered by the mortgage is free and clear of all liens other than the insured first mortgage and other liens that have been approved by the FHA Commissioner;
 - H. The mortgagee has voluntarily agreed to accept a PPC under the mortgage insurance contract and to recast the remaining mortgage amount under terms and conditions prescribed by the FHA Commissioner; and
 - I. The Owner has agreed to repay to the FHA Commissioner an amount equal to the PPC Claim amount, with the obligation secured by a second mortgage on the project containing terms and conditions prescribed by the FHA Commissioner.

The terms of the PPC Mortgage are standardized as described below, but each project is underwritten to ensure that the estimated project income will be sufficient to cover estimated operating expenses and debt service on the recast, insured first mortgage.

14-5. THRESHOLD REQUIREMENTS

- A. The Owner must meet the regulatory requirements set forth in Section 14-4., above, before the mortgagee may participate in a PPC.
- B. The mortgage must be in default at the time of the Application and must remain in default throughout the entire process until closing.
- C. The Application must demonstrate that the default is beyond the Owner's control, that conditions contributing to the default that are within the Owner's control have been resolved, that the project operations and occupancy are stabilized, and that a PPC is likely to result in long term stability of the project.
- D. The Application must verify that all possible financial resources available to the project have been utilized, including making all capital or equity calls, fulfillment of all guaranties, drawdown on all available lines of credit, etc. General Partner, Managing Member or other Owner-entity related parties often provide operating, working capital, and other types of cash flow related guaranties for projects. These guaranties are generally documented in the Partnership or LLC agreement, and/or in the financial statement notes, but they could be documented only in separate agreements. To ensure that HUD does not approve a PPC when such guaranties remain in effect or other resources remain available, Applications must include partnership or LLC agreements and any other relevant guarantee documents, as well as certifications as to the presence and status of all guaranties.
- E. The Owner must not have any other loans in any of HUD's multifamily housing programs in default (unless the default was beyond the control of the Owner) and the Owner must not be in violation of any HUD regulatory or business agreements, including Housing Assistance Payment (HAP) contracts or Use Agreements pertaining to any other property, including properties that have benefitted from PPC's or other workouts in the past.

-
- F. The Owner must have made Net Equity Contributions equal to or greater than five percent (5%) of the original mortgage amount, after final endorsement (or after the date of a subsequent HUD approved TPA). Contributions made prior to final endorsement will not be considered in the 5% calculation described below. Net Equity Contributions are defined as equity contributions or advances made by the Owner, less repayments to the Owner from the project's accounts. Owner contributions must have been in the form of cash. However, for non-profit Owners, in-kind services may be considered. Although payment of accounts payable may be allowed, accrued but unpaid Identity of Interest (IOI) expenditures (for management, ground leases, or similar costs) generally may not be considered as equity contributions unless requested and approved by the Hub/PC in advance of the transaction closing. In these cases such fees must be converted to a note and future (after PPC closing) fees must be treated similarly for years in which surplus cash is negative. The Owner's equity contributions can only be repaid from future distributions of the Owner's share of surplus cash.

Equity contributions and funds derived from operating guaranties are generally not included in the calculation of Net Equity: HUD includes in the Net Equity calculation only funds that were not committed prior to final endorsement. Accordingly investors' scheduled installment payments will not be included in the 5% equity contribution because they will have been committed to in advance of final endorsement. However, one exception may be made, in HUD's discretion. If investors' installment payments have not all been made when an Application is submitted to the Hub/PC, and the Owner agrees to use all or part of the remaining installment payment(s) to reduce the amount of the PPC, such amounts will be treated as Equity for purposes of the 5% Net Equity calculation. If this is the Owner's intention then a written commitment to this effect should be provided in the PPC Application.

Similarly, if a guarantee is executed prior to final endorsement, then funds paid in as a result of obligations under the guarantee will not be counted toward the 5% equity contribution.

- G. The Owner's cash flow projections must demonstrate the project's ability to support a new FHA-insured or conventional first mortgage with a debt service coverage ratio including Mortgage Insurance Premium of 1.20.
- H. The Owner must have submitted and continue to submit all net cash monthly to the mortgagee once the loan is in default.
- I. At the time of Application, the mortgagee must submit a letter agreeing to accept a PPC or mortgage modification with terms consistent with the requirements of this Chapter, if HUD decides to offer a PPC.
- J. Low Income Housing Tax Credit ("LIHTC") projects introduce greater underwriting complexity with respect to the ownership structures (LLCs or General Partnerships) and the financial obligations of various parties involved. Generally HUD's position is that all outstanding financial commitments to the project must be fully funded and/or expired prior to processing and approval of a PPC, and this premise guides HUD's practice for LIHTC Projects as well. The treatment of LIHTC investors' equity payments is addressed here, while the topic of operating deficits and similar

guaranties among partners, common in non-LIHTC projects as well, is addressed in 14-5.C above.

In an LIHTC financing, investors make a series of equity payments tied to development benchmarks and reserved to fund certain costs. In some cases, Applications have been submitted before the final installments have been paid in. HUD will generally require such payments to be used to reduce the PPC. As noted above however, if these installment payments are used to reduce the PPC they will be counted toward the Owner's 5% Net Equity Contributions.

14-6. MORTGAGE TERMS AND USE RESTRICTION

A. Terms of the Recast First Mortgage:

1. The interest rate for underwriting and approval of the recast first mortgage will be no higher than 125 basis points over the 10-year Treasury Rate (rounded to the nearest tenth) at the time of HUD approval. This rate must be a fixed rate and the mortgage must fully amortize over its term. Mortgagees are encouraged to place the loan at a lower rate. Any reduction from the approved rate will provide additional cushion to the recast note and will benefit the viability of the project on a long-term basis;
2. Late fees accrued since the last payment and costs to close must be paid at or prior to closing with funds not derived from the project;
3. HUD will include interest computed from the "Paid Through Date" on the mortgage based on the actual number of days in a 365 or 366-day year, in the PPC Note amount. The mortgagee cannot collect more interest than that amount from project funds;
4. Cash held in suspense by the mortgagee may be allowed by HUD to be used at closing to pay reasonable closing attorney fees, title and recording fees, escrow shortages, actual bond or GNMA fees, and interest for the remainder of the closing month. The PPC will not be increased if project cash is insufficient to cover these costs;
5. The mortgagee must agree that all prepayment lock-out and/or penalty provisions are overridden by the PPC; and
6. The mortgagee cannot charge the project a fee for processing a PPC.

B. Terms of the PPC Note and Mortgage:

1. The PPC Note has a principal amount equal to the amount of the PPC claim plus overdue interest;
2. The PPC Mortgage is in second lien position;
3. The Note interest rate is equal to the long term annual Applicable Federal Rate ("AFR") for the month of closing;

-
4. The term is equal to the remaining term of the first mortgage;
 5. The project Owner must make annual payments on the PPC Note in the amount of 75% of the project's surplus cash for the year in question; and
 6. The loan documents must have a due on sale or refinancing requirement.
- C. Use Restriction. If the property is already subject to a Land Use Restriction Agreement (LURA), the new HUD Use Agreement will mirror its requirements. For all other properties, the HUD Use Agreement will require (i) at least 30 percent of the units to be reserved for residents with incomes at or below 80 percent of Adjusted Median Income (AMI), at rents not to exceed 30 percent of 80 percent of AMI, or (ii) current affordability provisions on the project to continue, if more restrictive than in (i). These rents will be the initial basis for cash flow analysis. The new HUD Use Agreement will have a term of 20 years, which may exceed the remaining term of a prior LURA. As noted above, the HUD Use Agreement will reflect the requirements of the earlier LURA, and its requirements will remain in effect under the HUD Use Agreement even if the term of the original LURA lapses prior to the end of the new 20 year term. Samples of HUD Use Agreements to be used for projects with and without prior LURAs are available at the following web address:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/hsgmfbus/ab_outahp/oahp_wrkoutprog

Section 3. RESTRUCTURING OF HUD-HELD MORTGAGES

For purposes of this discussion a “Restructuring” is a workout for properties encumbered with HUD-held notes. These notes are formerly FHA-insured first mortgage notes that have been acquired by HUD in the course of a default and a full FHA Insurance claim. Restructurings are refinancings that require 1) a new 223(f) FHA-insured or an uninsured first mortgage offered by a third party that allows for a partial pay down of the HUD-Held note, and 2) recasting of the remaining principal balance of the HUD-Held Note to a new Restructuring Note. The Restructuring Note is subordinated to the new first mortgage, and is paid with 75% of surplus cash. Unlike a PPC, there is no new insurance claim involved in this transaction. To the extent that the new first mortgage provides better terms than the old and relieves the project of some of its first mortgage burden, the project’s operations will benefit and this will help to stabilize and preserve the housing.

14-7. APPLICABLE REGULATIONS

There are no applicable regulations for the Restructuring of HUD-Held Mortgages.

14-8. THRESHOLD REQUIREMENTS

Prior to the approval of a restructuring, HUD will make the following findings:

- A. The relief resulting from the refinancing and partial pay-down of the HUD-Held note, when considered with other resources available to the project, would be sufficient to restore the financial viability of the project;
- B. The project is or can at reasonable cost be made structurally sound;
- C. The management of the project is satisfactory to the FHA Commissioner, as demonstrated by a rating of at least satisfactory on the most recent management review;
- D. The project is serving, or potentially could serve as a low and moderate-income housing resource;
- E. The property covered by the mortgage is free and clear of all liens other than the new first mortgage and other liens approved by the FHA Commissioner;
- F. The Owner has agreed to substitute the existing HUD-held note, after its pay-down from a partial refinancing, with a new HUD-held note, (the Restructuring Note and Mortgage). The documents will contain terms and conditions prescribed by the FHA Commissioner. The terms of the Restructuring Note are standardized as described below, but each project is underwritten to ensure that the estimated project income will be sufficient to cover estimated operating expenses and debt service on the new first mortgage;

-
- G. The Owner must not have any other loans in any of HUD's multifamily housing programs in default (unless the default was beyond the control of the Owner) and the Owner must not be in violation of any HUD regulatory or business agreements, including Housing Assistance Payment (HAP) contracts or Use Agreements pertaining to any other property, including properties that have benefitted from PPC's or other workouts in the past;
- H. The Owner must have made Net Equity Contributions equal to or greater than five percent (5%) of the original mortgage amount, after final endorsement (or after the date of a subsequent HUD approved TPA). Contributions made prior to final endorsement will not be considered in the 5% calculation described below. Net Equity Contributions are defined as equity contributions or advances made by the Owner, less repayments to the Owner from the project's accounts. Owner contributions must have been in the form of cash. However, for non-profit Owners, in-kind services may be considered. Although payment of accounts payable may be allowed, accrued but unpaid Identity of Interest (IOI) expenditures (for management, ground leases, or similar costs) generally may not be considered as equity contributions unless requested and approved by the Hub/PC in advance of the transaction closing. In these cases such fees must be converted to a note and future (after Restructuring closing) fees must be treated similarly for years in which surplus cash is negative. The Owner's equity contributions can only be repaid from future distributions of the Owner's share of surplus cash;
- I. Equity contributions and funds derived from operating guaranties are generally not included in the calculation of Net Equity: HUD includes in the Net Equity calculation only funds that were not committed prior to final endorsement. Accordingly investors' scheduled installment payments will not be included in the 5% equity contribution because they will have been committed to in advance of final endorsement. However, one exception may be made, in HUD's discretion. If investors' installment payments have not all been made when an Application is submitted to the Hub/PC, and the Owner agrees to use all or part of the remaining installment payment(s) to reduce the amount of the Restructuring Note, such amounts will be treated as Equity for purposes of the 5% Net Equity calculation. If this is the Owner's intention then a written commitment to this effect should be provided in the Application.
- Similarly, if a guarantee is executed prior to final endorsement, then funds paid in as a result of obligations under the guarantee will not be counted toward the 5% equity contribution.
- J. The Owner's cash flow projections must demonstrate the project's ability to support a new Section 223(f) FHA-insured or conventional first mortgage with a debt service coverage ratio including Mortgage Insurance Premium of 1.20.
- K. Low Income Housing Tax Credit ("LIHTC") projects introduce greater underwriting complexity with respect to the ownership structures (LLCs or General Partnerships) and the financial obligations of various parties involved. Generally HUD's position is that all outstanding financial commitments to the project must be fully funded and/or expired prior to processing and approval of a Restructuring, and this premise guides HUD's practice for LIHTC Projects as well. The treatment of LIHTC investors' equity payments is addressed here, while the topic of operating deficit and similar

guaranties among partners, common in non-LIHTC projects as well, is addressed in 14-8.H above.

In an LIHTC financing, investors make a series of equity payments tied to development benchmarks and reserved to fund certain costs. In some cases Applications have been submitted before the final installments have been paid in. HUD will generally require such payments to be used to reduce the amount of the new Restructuring Note. As noted above however, if these installment payments are used to reduce the amount of the new Restructuring Note they will be counted toward the Owner's 5% Net Equity Contributions.

14-9. MORTGAGE TERMS AND USE RESTRICTION

- A. New First Mortgage Terms. As described above, a Restructuring is a substitution and partial pay-down of the first mortgage debt. In the course of this refinancing, the original HUD-Held Note is partially paid down with a new first mortgage loan, and the remaining balance on the HUD-Held Note is recast into a new second mortgage obligation, the Restructuring Note and Mortgage. The terms on the new first mortgage include the following:
1. The interest rate for underwriting and approval of the new first mortgage will be no higher than 125 basis points over the 10-year Treasury Rate (rounded to the nearest tenth) at the time of HUD approval, This rate must be a fixed rate and the mortgage must fully amortize over its term. New mortgagees are encouraged to place the loan at a lower rate. Any reduction from the approved rate will provide additional cushion to the new first note and will benefit the viability of the project on a long term basis; and
 2. HUD will waive any late fees or prepayment penalty.
- B. Restructuring Note and Mortgage Terms. The terms of the new second mortgage obligation are as follows:
1. A principal amount equal to the outstanding principal balance of the original HUD-Held Note after that balance is reduced by a partial pay-down using the new first mortgage funds;
 2. Second lien position;
 3. An interest rate equal to the amount of the long term annual AFR for the month in which it is originated;
 4. A term equal to the term of the new first mortgage;
 5. Annual payments on the Restructuring Note in the amount of 75% of the project's surplus cash for the year in question, due within 10 calendar days of the required filing of the Annual Financial Statement; and
 6. A due on sale or refinancing requirement.

-
- C. Use Restriction. If the property is already subject to a Land Use Restriction Agreement (LURA), the new HUD Use Agreement will mirror its requirements. For all other properties, the HUD Use Agreement will require (i) at least 30 percent of the units to be reserved for residents with incomes at or below 80 percent of Area Median Income (AMI), at rents not to exceed 30 percent of 80 percent of AMI, or (ii) current affordability provisions on the project to continue, if more restrictive than in (i). These rents will be the initial basis for cash flow analysis. The new HUD Use Agreement will have a term of 20 years, which may exceed the remaining term of a prior LURA. As noted above the HUD Use Agreement will reflect the requirements of the earlier LURA, and its requirements will remain in effect under the HUD Use Agreement even if the term of the original LURA lapses prior to the end of the new 20 year Use Agreement term. Samples of HUD Use Agreements to be used for projects with and without prior LURAs are available at the following web address: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/hsgmfbus/aboutahp/oahp_wrkoutprog

Section 4. MODIFICATIONS

The final type of transaction addressed in this Chapter is a modification of an FHA-insured mortgage ("Modification"). Through this approach an existing defaulted FHA-insured loan is modified through a reduction in interest and/or extension of its term, to stabilize the project. It will not result in a claim on the FHA General Insurance Fund however, nor will it involve creation of a second note. If the loan was bond financed, the lockout and/or prepayment prohibitions will be addressed as described in Mortgagee Letter 87-9. A Modification is designed to achieve several of the same benefits that can be obtained through a PPC: Preserving or providing affordable housing, stabilizing project operations, and maximizing longer term returns to the FHA General Insurance Fund.

14-10. APPLICABLE REGULATIONS

The applicable regulations for the Modifications provided for in this Chapter are at 24 CFR 207.256b.

14-11. THRESHOLD REQUIREMENTS

Prior to the approval of a Modification, HUD will require the following findings:

- A. The relief resulting from the Modification, when considered with other resources available to the project, would be sufficient to restore the financial viability of the project;
- B. The project is or can, at reasonable cost, be made structurally sound;
- C. The management of the project is satisfactory to the FHA Commissioner, as demonstrated by a rating of at least "Satisfactory" on the most recent Management and Occupancy Review;
- D. The default, if any, under the insured mortgage was beyond the control of the Owner;
- E. The project is serving, or potentially could serve as a low and moderate-income housing resource;
- F. The property covered by the mortgage is free and clear of all liens other than the insured first mortgage and other liens approved by the FHA Commissioner;
- G. The mortgagee has voluntarily agreed to accept a Modification under the mortgage insurance contract under terms and conditions prescribed herein;
- H. The Owner must not have any other loans in any of HUD's multifamily housing programs in default (unless the default was beyond the control of the Owner) and the Owner must not be in violation of any HUD regulatory or business agreements, including Housing Assistance Payment (HAP) contracts or Use Agreements

pertaining to any other property, including properties that have benefitted from PPC's or other workouts in the past;

- I. The Owner's cash flow projections must demonstrate the project's ability to support the modified debt, and cash flow must support 100 percent of the modified outstanding mortgage;
- J. The Owner must have submitted and continue to submit all net cash monthly to the mortgagee if the loan is in default; and
- K. The mortgagee must submit a letter agreeing to accept a Modification with terms consistent with all of the applicable requirements of this Chapter.

14-12. MORTGAGE MODIFICATION TERMS AND USE RESTRICTIONS

A. Terms of Modifications. The Modification to the existing first mortgage may involve changes in a ~~loan's~~ loan's interest rate, and/or maturity date, producing a change in the payment amount, within the following parameters:

- 1. The loan must be fully amortized over the course of its term;
- 2. The remaining term of the mortgage must be at least 10 years;
- 3. There must be sufficient net operating income to support debt service;
- 4. If the property is serving or was designed to serve low and very low income tenants, then the rents after the modification must continue to be affordable to those tenants;
- 5. The interest rate for underwriting and approval of the modified first mortgage must not exceed a rate low enough to allow for debt service coverage of 1.0;
- 6. Late fees accrued since the last payment and costs to close must be paid at or prior to closing with funds not derived from the project; and
- 7. The mortgagee cannot charge the project a fee for processing a Modification.

B. Use Restriction.

If the property is already subject to a Land Use Restriction Agreement (LURA), the new HUD Use Agreement will mirror its requirements. For all other properties, the HUD Use Agreement will require (i) at least 30 percent of the units to be reserved for residents with incomes at or below 80 percent of Area Median Income (AMI), at rents not to exceed 30 percent of 80 percent of AMI, or (ii) current affordability provisions on the project to continue, if more restrictive than in (i). These rents will be the initial basis for cash flow analysis. The new HUD Use Agreement will have a term of 20 years, which may exceed the remaining term of a prior LURA. As noted above the HUD Use Agreement will reflect the requirements of the earlier LURA, and these

requirements will remain in effect under the HUD Use Agreement even if the term of the original LURA lapses prior to the end of the new 20 year term. Samples of HUD Use Agreements to be used for projects with and without prior LURAs are available at the following web address:

http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/hsgmfbus/ab/outahp/oahp_wrkoutprog

Section 5. APPLICATION, REVIEW AND APPROVALS FOR ALL TRANSACTIONS

14-13. SUBMISSION OF APPLICATION

Prior to submission of a formal Application for any of the transactions described above, the Applicant should have discussed the property's financial difficulties with the Project Manager. For PPCs, the proposal must be submitted within 60 calendar days of default. When in default or facing long term difficulty paying a project's debt service, the Owner must provide Monthly Accounting Reports to the Hub/PC at least until such time as the PPC, Restructuring or Modification has closed, or later as required by the Hub/PC.

A complete Application package required for PPCs, Restructurings and Modifications, contains all of the following:

- A. A cover letter stating the type of request, whether for a PPC, Restructuring or Modification, and the parameters and conditions of the request. The package must include:
 - 1. The amount of a recast first mortgage (or new first mortgage in the case of a Restructuring) that is supportable by cash flow;
 - 2. An anticipated closing date, generally within four months of the date of the request;
 - 3. A thorough discussion of the operational, physical and financial problems resulting in difficulty paying debt service and leading to default;
 - 4. Specific steps that have been taken to overcome problems identified in 3. above, such as development and implementation of a new marketing or tenant retention strategy, revised lease up procedures, and/or measures to control expenses, along with an assessment of their effectiveness;
 - 5. If the project has received a less than "Satisfactory" rating in any section of the Management and Occupancy Review or any deficiencies on the last HUD Physical Inspection, the Owner must provide written comments regarding the status of any corrective action. These should indicate what repairs have been completed, what other corrective actions have been taken, and target dates for completing all remaining actions. (Note: copies of reports and Owner's responses should be provided as well);
 - 6. A discussion of how the project meets all the regulatory and threshold requirements for the type of transaction proposed. (See Sections 14-4. and 14-5. for PPCs, Sections 14-7. and 14-8. for Restructurings, and Sections 14-10. and 14-11. for Modifications);
 - 7. Discussion regarding the availability of additional financial support that could be utilized for the project, such as guarantees, letters of credit, etc.;

-
- B. Additional information to support the request, including but not limited to letters reflecting local support, how the property is providing or will provide good quality and needed affordable housing (preservation worthiness), and any other related information;
 - C. If any part of the submission requires a waiver to the provisions of any handbook or regulation, a discussion of the need for the waiver and why it is in HUD's best interest to approve the waiver;
 - D. Certified rent rolls for the three months immediately prior to the month of application;
 - E. Last twelve months' occupancy statistics including physical and economic vacancy rates;
 - F. Summary of current concessions being offered at the property;
 - G. Management agent's market assessment and marketing plan;
 - H. For PPCs and Restructurings only, a statement of Owner's Net Equity Contributions, defined as contributions or advances by the Owner, less repayments to the Owner. Owner contributions must generally be in the form of cash. However, for non-profit organizations the value of in-kind services may be considered. Accrued but unpaid Identity of Interest (IOI) expenditures (for management, ground leases, or similar costs) generally will not be considered unless requested and approved by the Hub/PC in advance of the transaction closing, in which case these fees must be converted to a note and future (post closing) fees must be treated similarly for years in which surplus cash is negative. A certified statement by an independent public accountant or a certified public accountant must be provided to verify these amounts, showing all advances and repayments to the Owner. Funds deposited due to calls on Letters of Credit shall not count as Owner contributions. Equity contributions and funds derived from operating guaranties and similar financial commitments are generally not included in the calculation of Net Equity either: HUD includes in the Net Equity calculation only funds that were not committed prior to final endorsement. Accordingly investors' scheduled installment payments and payments resulting from cash flow and other guaranties, even if these payments occur after final endorsement, will not be included in the 5% equity contribution because they will have been committed to in advance of final endorsement. The analysis should verify that the contributions are actually new funds from the Owner and not (re)deposited project funds, and that all contributions were made after final endorsement. This statement should include, but is not limited to the following:
 - 1. Contributions/advances made by the Owner to the project accounts after final endorsement (excluding equity installment payments committed to by investors prior to final endorsement);
 - 2. Distributions and repayments made to the Owner from the project accounts after final endorsement; and
 - 3. The total net contributions comprised of the total of the contributions less distributions and repayments to the Owner.
-

Note: Owner contributions can only be repaid from future distributions of the Owner's share of surplus cash.

- I. Partnership or LLC agreements and any guarantee or similar documents, and a certification stating that all future equity installments, guarantees or similar resource commitments to the project have been disclosed, and describing the current status of all outstanding equity installments and guaranties or similar resource commitments.
- J. Copies of the current year's budget and budget variances year-to-date, most recent unaudited interim balance sheet and income and loss statement, and the last three fiscal years' audited financial statements. These statements must also be used by the Owner to develop and provide projections for 10 years post closing. Projections should detail trending assumptions, and any changes in operations that result in deviations from historical results should be noted and justified.
- K. A written narrative concerning the property's condition and the adequacy of the replacement reserve;
- L. A Project Comprehensive Needs Assessment (PCNA) completed by an independent third party contractor using HUD guidelines if any of the following conditions apply:
 - 1. The property has replacement reserves of less than \$250/unit at the time of the Application; or
 - 2. No PCNA has been completed within the 10 years prior to the date of the Applicant's request; or
 - 3. The property has a Real Estate Assessment Center (REAC) physical inspection score below 80 points. Under this requirement only, a PCNA can be waived by the Hub prior to submission. The Hub will consider the specific deductions in the REAC report along with results from any site visits made by HUD or a Performance Based Contract Administrator (PBCA) staff person in determining whether a PCNA is necessary.

Note: If a PCNA dated no more than 5 years prior to the date of the Applicant's request is available, it may be updated and substituted for a new PCNA required under the conditions described above.

- M. If no PCNA is required, then the Applicant must deliver a 20 year replacement reserve study ("Reserve Study") demonstrating that current Reserve for Replacement (R4R) funds, in conjunction with ongoing annual R4R contributions, are adequate to fund the project's future physical needs. This study must include useful life and the anticipated timing and cost of replacement of all interior and exterior building elements, mechanical systems and unit components, as well as any exterior grounds needs, in a format acceptable to the Field Office and to OAHP. A sample format may be provided but is not required for Applicants' use.
- N. A recent (within the past 12 months) market study if available.

-
- O. Statements from the Owner, the first mortgagee and other lien holders, if any, stating that they will agree to accept a Use Agreement that will be superior to all other liens. The Use Agreement will have a term of 20 years from the date of the Closing and will specifically state that the management cannot discriminate against Section 8 voucher holders.
 - P. Disclosure of the project names, FHA numbers and a narrative summary of current performance of any other formerly or currently FHA-insured properties that 1) have had prior PPCs, Modifications or Restructurings, and 2) are owned by any principals of the Owner or their affiliates.
 - Q. A completed “Draft Partial Payment of Claim Model” or other financial analysis demonstrating the terms of the Applicant’s proposed PPC, including the project’s operating budget, long term cash flow pro forma, and other relevant financial information.
 - R. Additional information that may be requested after submission of the Application by the Hub/PC or by OAHP during the course of the review.

A “Draft Applicant’s Checklist For Submission to the Hub/PC”, for all transactions contemplated in this Chapter is recommended but not required for the Applicant’s use in preparing the Application, and it is available on OAHP’s website at the following address:
http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/hsgmfbus/aboutahp/oahp_wrkoutprog

14-14. HUB/PROGRAM CENTER (HUB/PC) RESPONSIBILITY

HUD’s review of a PPC, Restructuring or Modification request takes place in two phases: The first is carried out by the Hub/PC overseeing the project in question, and the second by the Office of Affordable Housing Preservation/Multifamily (OAHP) at Headquarters. The Applicant must submit an Application to the Hub/PC. Then the Hub/PC must determine that the Application is complete and carry out other steps listed below. This work should be completed within 15 calendar days of receipt of the complete Application. If the Application is incomplete, the lead staff person must notify the Applicant of missing materials immediately and place the request on hold until those materials are provided.

If the Election to Assign date for a project with a pending PPC is imminent, then the Owner must advance the funds necessary to keep the loan in “rolling default”⁵ and prevent the assignment, or the PPC or Modification process will be terminated. When the Application is deemed complete, the Hub/PC will forward the Application to OAHP for processing. The processing steps to be completed in the Hub/PC during this first stage in the process include the following:

- A. Review the Application to make sure it is complete, and if not complete, collect missing materials prior to forwarding the package to OAHP. Note that the primary intention here is only for the Hub/PC to verify that documents or statements addressing each requirement have been provided, and not to thoroughly review or analyze all documents or statements for content, accuracy or consistency;

⁵ “Rolling default” means that the Owner never has more than two unpaid payments and that no more than 75 calendar days have elapsed since the earliest current missed payment date.

-
- B. Verify project eligibility according to Sections 14-2. and 14-3. (mortgage insurance eligibility);
- C. Complete the 2530 Clearance, if required;
- D. Identify comparable properties near the project, and collect relevant peer information for inclusion in the package to OAHP, along with a brief narrative analysis as to market comparability of the chosen projects with the Applicant's project; and
- E. Provide a cover letter to OAHP including the following:
1. A statement that the Hub/PC has determined that the proposed transaction (PPC, Modification or Restructuring) is the best strategy for the property, based on its knowledge of the project, the market, and any other strategies that might be available;
 2. A confirmation that project reserves are adequate based on the PCNA or Reserve Study supplied by the Applicant. If reserves are not adequate, the Hub/PC will work with the Owner to develop an agreement establishing appropriate one time reserve contributions in conjunction with the PPC as well as adjustments to annual reserve deposits if necessary;
 3. A determination that the Owner and management agent have the capability to resolve current and future problems, through review of the Owner's discussion of the problems that led to the need for a workout, and steps taken to overcome both past and present problems. The analysis must include a review of HUD files and systems to confirm that the problems were beyond the control of the Owner. Available Management and Occupancy Reviews (MORs) must be analyzed. If a MOR has not been conducted within the last twelve months, a site visit by Hub/PC staff to review project operations is strongly encouraged. Owner and management agent capacity should be described thoroughly, and finally, this assessment of the project's management agent should conclude with a recommendation to OAHP as to whether the current management agent should be retained or replaced; and
 4. Provision of any other special information or circumstances pertaining to need for the housing, preservation worthiness, etc., that should be considered and might not otherwise be identified in the course of the headquarters review.

Note: The "Hub's Checklist for Submission to OAHP should be used by the Hub for submitting their packages to OAHP, and it may be found at the following address: http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/hsgmfbus/about_ahp/oahp_wrkoutprog

As the process moves forward at OAHP, the Hub/PC will retain responsibility for each of the following;

- F. Advising OAHP and helping to coordinate the work of the Applicant, OAHP and the Hub/PC as needed through the process; and

G. Tracking, approving or rejecting, and notifying OAHP of all Extensions of the Lender's Election to Assign the Mortgage.⁶

Note: HUD will not grant any extensions of the Election to Assign the Mortgage for submission delays following the default or processing delays resulting from the lack of a PCNA or other required document.

14-15. HEADQUARTERS/OAHP REVIEW

OAHP's role is to provide the full analysis and underwriting necessary to achieve a balanced assessment of the long-term impact of the proposed transaction on the project, factoring in the cost to the FHA General Insurance Fund and various other considerations. OAHP's analysis will utilize the PPC Analysis Model for all transactions contemplated in this Chapter. This model helps to perform a real estate feasibility analysis and calculates the amount of the partial payment of claim in the case of a PPC, and the amount of the remaining or new first mortgage debt that a project can carry successfully in the case of a Restructuring or Modification. The most recent version of the model is available to all HUD staff on HUD's Intranet, and Applicants are encouraged but not required to utilize the model as part of their submission. Applicants may call their HUD Field Office Project Manager to request a copy, and it is essential for Applicants to start with a newly downloaded copy of the latest version for each project.

The Associate Deputy Assistant Secretary, OAHP, has the delegated authority to offer a PPC, Restructuring or Modification Application based on the following analysis:

- A. Verification of the Owner's compliance with all business agreements with the Department, utilizing available sources to see if Ownership and/or management are involved with other properties and noting any flags related to those properties to assist in the analysis.
- B. Verification of the Owner's Net Equity Contributions through the accountant's statement and the project's financial statements (for PPCs and Restructurings only).
- C. Confirmation or revision of the Hub/PC's recommendation with respect to retention or replacement of the management agent;
- D. Review of Monthly Accounting Reports (MARs) to determine if all net cash is being remitted to the mortgagee, if they are consistent with the Applicant's projections for income and expenses, and whether or not funds are spent only on reasonable and necessary operating expenses. HUD will use the PPC Analysis Model to determine

⁶ The mortgagee must make several entries into HUD's MDDR system during the course of a PPC. These begin with Notices of Delinquency, and later, Default, which are followed eventually by an Election to Assign the mortgage to FHA. MDDR and HUD regulations also impose certain timing requirements with respect to PPCs. Extensions of the Election to Assign allow deferral of submission of the Election to Assign. However, as long as the mortgage remains in "rolling default", written extensions from the Field Office are not needed.

base year (first full year after transaction closing) Net Operating Income (NOI). This entails review of the project's income, expenses, vacancy rate, and NOI as submitted by the Applicant and making of adjustments where necessary. The following four categories must be addressed by the underwriter:

1. Income: All sources of income and adjustments to income must be analyzed. This may include, but is not limited to residential rents, parking, commercial space rents, laundry, tenant charges and historical bad debt. The impact of the proposed use restriction, if it will reduce rents or affect vacancy rates, should also be examined;
 2. Economic Vacancy Rate: This is verified by reviewing the current rent roll and comparing actual rents with the approved rent schedule. Note: The economic vacancy rate takes into consideration the concessions and rent reductions that the Applicant may have used to increase the physical occupancy of the project. Because of concessions like these, the project may have a reasonable level of occupancy, while the income is still insufficient to pay all expenses and debt service. The economic vacancy should show a flat or decreasing trend over the last six months;
 3. Expenses: These are determined by reviewing historical data (annual and interim), current year budgets and post closing projections; and
 4. Replacement Reserves: Review of the Hub/PC's assessment of the reserves and of the Reserve Study to be prepared in certain cases and agreed upon with the Owner, if necessary. The plan should take into account the balance in the replacement reserves, any suspension of deposits, age of the property and physical condition reports (if available) to ensure that at Closing the replacement reserve account is adequate and that future monthly deposits will be sufficient for the property's needs.
- E. Analysis of past performance of the property and comparison of expense results to a peer analysis delivered by the Hub/PC. If the comparison shows significant unexplained deviations from peer properties that reveal a default due to ownership action or inaction, the proposed transaction may not be successful. Consultation with staff appraisers and other HUD development staff may be part of this analysis step.
- F. Confirmation that the Draft PPC Model will calculate a supportable first mortgage. For PPCs and Restructurings the interest rate on the recast or new first mortgages must not exceed 125 basis points over the current 10-year Treasury Rate (rounded to the nearest tenth.) A minimum Debt Service Coverage Ratio (DSCR) of 1.20, including Mortgage Insurance Premium (MIP) is required for the base year. For Modifications, the rate will be that proposed by the mortgagee, not to exceed the original rate.

In the case of PPCs, the supportable recast first mortgage must be at least 50 percent of the unpaid principal balance (UPB) prior to the PPC, and no waiver is granted. However, the Owner may be offered an opportunity to increase the Owner contribution to cover the amount needed to achieve the 50 percent minimum remaining balance, if any. The Owner should be notified and must agree in writing within ten (10) calendar days of notification: Otherwise the PPC must

be rejected. However, if the 50 percent test is not met solely due to an increase in interest rates since submission, no additional Owner contribution will be required.

The Draft PPC Model will calculate the amount of the PPC Note or Restructuring Note. For PPCs, HUD will include in the second mortgage amount all interest owed at the current first mortgage note rate (less any additional contributions required to achieve the 5 percent Net Capital Contribution requirement). All fees and late charges must be waived by the mortgagee. The PPC and the Restructuring Notes will have a maturity date equal to that of the recast first mortgage, be callable at maturity of the Use Agreement, have an interest rate equal to the applicable Federal Rate for the month of closing, and require payments equal to 75 percent of surplus cash annually after filing of the annual financial statement. The notes must also contain a “due on sale or refinancing” clause. This paragraph is not applicable to Modifications.

14-16. OFFER, APPROVAL, REJECTION AND APPEALS

It will be OAHP’s responsibility to prepare recommendations for all Applications when underwriting is complete, using the process outlined below. Projects that do not meet fundamental regulatory or threshold requirements however, as well as those without complete Applications, will not be fully reviewed or presented to the Committee. OAHP is required to adhere to the following steps:

- A. A Multifamily Workout Committee comprised of 1) two senior management staff members of OAHP, 2) one senior management staff member of Asset Management, and 3) the respective Hub/PC Director. This Committee will review and make a determination with respect to all of the eligible and complete Applications submitted.
- B. Voting members include the OAHP and Asset Management members, and a quorum of three is required for any such decision.
- C. When projects are ready for Committee review, OAHP staff will schedule a meeting to present recommendations and financial analyses, along with a final Draft PPC Model, a narrative summary and a Term Sheet, for distribution to the Committee members in advance of the meeting. The Term Sheet will describe all of the conditions under which a PPC could be approved and it will specifically address the risks of the transaction and how such risks are to be mitigated.
- D. The Multifamily Workout Committee will review the staff’ analysis and authorize staff to issue the Term Sheet to the Applicant if it is acceptable to the Committee.
- E. Approval of Application. When the Owner accepts the Term Sheet and the mortgagee submits the Election to Assign in the MDDR system, the Associate Deputy Assistant Secretary (“ADAS”), OAHP will sign a formal Acceptance Letter reflecting the Terms and Conditions of the Term Sheet, to be sent to the Owner and Mortgagee. At the same time the Draft PPC Model will be adjusted to reflect that day’s first mortgage interest rate (125 basis points over the 10 year Treasury rate), which will be the approved rate of the mortgage. The Owner and Mortgagee are required to counter-sign the Acceptance Letter and return it to the ADAS.

-
- F. Rejection of Application. If the Application does not meet the requirements, the ADAS, OAHP will send a letter to the Applicant notifying him/her of the reasons for HUD's decision and obtain proof of delivery.
- G. Administrative Review. If the Application is rejected by the Committee, the Applicant may request an Administrative Review of the decision.
1. This request must be received by the Administrative Appeals Officer (AAO) within 10 calendar days of the Owner's receipt of OAHP's letter rejecting the transaction. It must be made in writing and it must clearly state the reasons for the Owner's objection to the decision: It may also contain any additional information in support of the objections that the Owner wishes to be considered.
 2. The scope of administrative review of the Appeal Decision will be limited to a determination of whether the Committee's decision is:
 - a. Reasonable in light of the facts and circumstances; and
 - b. In accordance with all applicable statutes and regulations.
 3. Within 15 calendar days after receipt of the Owner's request to the AAO, the AAO shall issue a decision (the "AAO Decision"). The AAO Decision will be in writing and specifically address the objections raised by the Owner.

The AAO Decision is final. After any administrative review period has expired and if the mortgage is not reinstated, the mortgagee will be instructed by the Hub/PC Director to process a full claim for mortgage insurance benefits.

4. Owner's Acceptance of PPC Terms. Acceptance of OAHP's PPC terms is verified through the Owner's signature on the Term Sheet and the mortgagee's submission of an Election to Assign the mortgage to FHA. However, the Election to Assign will be suspended in MDDR until such time as closing is virtually certain, since once it is accepted, the PPC must be closed or the property assigned within 30 calendar days. (Two 30 day extensions of this initial 30 day period are allowed if necessary, but if closing does not occur within 90 calendar days of FHA's acceptance of the mortgagee's Election to Assign, the mortgagee must assign the loan to FHA.) To continue the process after 90 calendar days, OAHP must obtain a regulatory waiver from the FHA Commissioner. Once the PPC is closed the mortgage should be reinstated in the MDDR system.
 5. Following the Owner's acceptance of PPC Terms, no further payments should be applied to the mortgage. The mortgagee should continue to collect all net cash but maintain the funds in a suspense account. This is not applicable to Modifications or Restructures.
 6. If a PPC Term Sheet is accepted or a Modification or Restructure has been approved, GNMA will allow the transaction to proceed, regardless of the payment status.
-

Section 6. CLOSING REQUIREMENTS FOR ALL TRANSACTIONS

OAHP will collect all documents detailed below from the Hub/PC, Owner, and mortgagee. Upon receipt, the documents for all transactions will be reviewed for consistency under the approved Term Sheet and distributed to the appropriate staff within the Office of General Counsel (OGC). PPC documents will also be delivered to the Multifamily Claims Branch, and Modification Documents and Restructuring Documents to the Notes Servicing Office.

14-17. FIRST MORTGAGE TERMS

- A. The original First Mortgage will be adjusted to reflect:
1. A principal balance reduced in the case of a PPC or Restructuring, and unchanged in the case of a Modification;
 2. For PPCs and Restructurings, a maximum interest rate of 125 basis points over the 10-year Treasury Rate (rounded up to the nearest fifth or tenth) at the time of HUD's approval. This rate must be a fixed rate and the mortgage must fully amortize over its term;
 3. The original maturity date or a new maturity date as specified in the Offer or Approval;
 4. Monthly payments and a new amortization schedule based on 1. through 3. above;
 5. Subordination of the Restructuring Note to a new first mortgage;
 6. If requested by the mortgagee, the First Mortgage Note may include a restriction on prepayment for the purpose of enhancing the marketability of the new GNMA Mortgage-Backed Security. Any prepayment restriction must be prepared in accordance with Mortgagee Letter 87-9;
 7. If the mortgage servicer is unable to offer or place a recast first mortgage (PPCs) or a new first mortgage (Restructuring) with a GNMA investor at the rate approved above, HUD may consider a modification to the rate and size of the mortgage. To obtain a higher rate, the mortgage servicer must certify to the Director of Asset Management, HUD Headquarters, that it has made its best efforts to place the loan at the approved rate. As part of this certification, it further certifies that it has provided the secondary market the following terms:
 - a. Minimum DSC including MIP and deposits to the replacement reserves of 1.20 for PPCs and Restructurings, and 1.0 for Modifications;
 - b. Inclusion of lockout and prepayment penalty;
 - c. 20-year Use Agreement and 20-year call provision;

-
- d. Owner's pledge that no IOI payments will be paid from project cash flow in years of deficit surplus cash;
 - e. Cash flow dependent upon the model's underwritten economic vacancy percentage for the base year;
 - f. A minimum of three rate bids from major parties that will result in the placement of the recast mortgage in a REMIC transaction; and
 - g. Certification that documentation of information provided to investors will be retained for three years for HUD review at the servicer's office. If in compliance, proprietary information will not be copied or retained by HUD.

NOTE: If requested, HUD will make available its approved underwriting model to the mortgage servicer after the decision process and all appeal opportunities are concluded.

NOTE: If a certification containing the conditions above is received from the mortgage servicer, HUD will allow the rate to increase by up to 50 basis points without further HUD approval.

8. In the event the first mortgage is prepaid and there is no additional debt with HUD mortgage insurance, the Owner will furnish HUD and the note holder with audited annual financial statements until the PPC or Restructuring Note is satisfied;
 9. The Owner may not incur additional debt without the prior written consent of HUD and the note holder; and
 10. The PPC or Restructuring Note holder (subject to the rights of the first mortgage lender) has the right to foreclose on the security interest in the surplus cash, perfected by filing of a UCC-1 Financing Statement, in the event of a default on the Note.
- B. The terms of the second mortgage (the PPC Note or the Restructuring Note) will be as follow:
1. Owner and mortgagee consent to a second, HUD-held mortgage;
 2. An interest rate equal to the applicable Federal Rate for the month of closing;
 3. Maturity date coterminous with that of the first mortgage;
 4. A "due-on-sale, refinance, or termination" provision;
 5. Subordination of the Restructuring Note to the new first mortgage;
 6. As long as the Note is held by HUD, a service charge calculated at one half (0.5) percent annually based on the unpaid principal balance of the PPC Note or Restructuring Note must be paid to HUD monthly from project funds prior to the surplus cash flow split calculation;

-
7. The annual payment on the PPC Note or Restructuring Note, if surplus cash is available, will be 75 percent of annual surplus cash as specified in the Regulatory Agreement between the Secretary of Housing and Urban Development and the project Owner, together with other applicable HUD Regulations and administrative requirements. The surplus cash payment on the PPC and Restructuring Notes is due within 10 calendar days of the required filing of the Annual Financial Statement. Owner's share shall be 25 percent of surplus cash and is only payable to Owner concurrently with payments on the PPC or Restructuring Notes. The annual payment on the PPC Note or the Restructuring Note will be applied towards interest first, and then principal;
 8. A call provision on the maturity date of the Use Agreement, at which time HUD, or the Second Note Holder, at its sole option, may require the full payment of, or provide the Owner the opportunity to propose a restructuring of the debt; and
 9. Language prohibiting successors and assigns of the beneficiary of the PPC or Restructuring Note from imposing property insurance requirements that exceed the original principal balance contained in the First Mortgage or Deed of Trust Note, or are in addition to those required by the First Deed of Trust Holder or First Mortgage Note Holder so long as the First Mortgage Note is held or insured by the Secretary of HUD.

C. Other Terms and Conditions of the PPC and Restructuring Transactions:

1. If IOI expenditures have been included as an Owner's contribution in calculating eligibility for a PPC, then a requirement that those expenditures cannot be taken or must be re-deposited for any year in which surplus cash is negative (not to exceed the amount of the negative surplus cash amount) will be imposed. The redeposit or accrual can only be repaid from the Owner's share of surplus cash in future years;
 2. The monthly deposit to the Reserve for Replacement Account (RFR) will resume with the first payment of the recast first mortgage. (Previous deposits will not have to be made up, unless the reserve balance has been determined to be inadequate);
 3. As long as the PPC Note or Restructuring Note is outstanding, all eligible RFR expenses must be paid through the RFR account and invoices must be submitted for reimbursement during the calendar year in which the work was completed;
 4. All escrows, such as tax, hazard insurance and mortgage insurance premium (MIP) shall be fully funded at closing;
 5. All IOI payables older than 30 calendar days must be converted to notes payable and can only be repaid from the Owner's share of surplus cash or paid by the Owner prior to closing;
 6. All other payables (i.e. non-IOI payables) are to be cleared at closing;
 7. Under no circumstances may changes be made to the documents reviewed other than to conform to the terms and conditions of the approval, without HUD's specific authorization. The Hub/PC Counsel, and/or Headquarters' Office of General Counsel, may modify the documents to conform to local legal requirements;
-

-
8. If the insured First Mortgage is repaid, the Owner must establish and maintain continued funding of all escrows required by the First Mortgage until the second is repaid in full;
 9. If at any time during the term of this agreement, HUD determines that there has been an uncorrected material violation of a Regulatory Agreement, Housing Assistance Payments Contract, HUD Use Agreement, or any other contractual or regulatory provision governing the operations of the project, the interest rate on the PPC or Restructuring Note will revert to the rate of the original first mortgage note in effect prior to the Modification, Restructuring or PPC, if a notice and a right to cure have been provided to Owner;
 10. Project operating income may not be used to pay financing fees, attorney fees, consultant fees, other professional fees, or any other costs of the restructuring transaction. The Owner's share of future surplus cash may be used for these purposes only if available for distribution in accordance with HUD regulatory requirements and applicable policy guidelines;
 11. Cash held in suspense by the mortgagee will be allowed by HUD to be used at closing to pay reasonable closing attorney fees, title and recording fees, escrow shortages and interest for the remainder of the closing month. The PPC or Restructuring Note will not be increased if project cash is insufficient to cover these costs;
 12. HUD will include the interest computed since the date of delinquency in the PPC Note amount, based on the actual number of days in a 365- or 366-day year. The mortgagee cannot collect more interest from the project than the amount paid by HUD. Late fees accrued since the last payment or any other costs to close cannot be included in the transaction or paid by the project in the future;
 13. The Sources and Uses of Funds Statement for any of the Applications may not show disbursements of funds to the Owner;
 14. No funds may be paid at closing to identity-of-interest persons or entities. The Sources and Uses of Funds Statement must also be signed and certified by the Owner or representative; and
 15. The Owner and the servicer/mortgagee of the first mortgage loan must provide notices and documentation to the PPC or Restructuring Note holder upon the occurrence of events that could materially affect the value and position of the second mortgage mortgagee such as full or partial payment of principal on the first mortgage loan, events of default on the first mortgage loan, declaration of bankruptcy by the Owner, and any documentation related to a bankruptcy or any foreclosure action.

14-18. SCHEDULING THE CLOSING

Upon receipt of HUD's approval letter, the Owner and mortgagee must confirm or request adjustment to OAHP's targeted closing date with OAHP's Closing Coordinator. The closing must

occur within 60 calendar days from the date of notification of OAHP's approval. The Owner's requested date will be accommodated to the extent possible but OAHP's Closing Coordinator, in cooperation with the OGC Reviewer, has the final authority to set the closing date.

Within ten (10) calendar days of receipt of Owner's acceptance of the Term Sheet and notification of the target closing date, the Closing Coordinator will coordinate with OGC Counsel in Headquarters and with Multifamily Claims Branch and Notes Servicing in the case of a PPC or Restructuring, to confirm the projected closing date or suggest alternative dates if the Owner's dates cannot be accommodated. Delays due to Owner's, mortgagor's or other party's action or inaction will be deemed the Owner's responsibility. The Owner is strongly encouraged to meet the targeted closing dates, as delays may be costly. Once the amount of the PPC or Restructuring Note is determined, any increase in the funds required to close (i.e., interest) must be funded by the Owner at closing.

14-19. CLAIMS BRANCH PROCESS (PPCs ONLY)

HUD's Multifamily Claims Branch will be involved only in PPCs as the other types of transactions do not involve FHA General Insurance Fund claims. Consequently this section applies only to PPCs and not to Restructurings or Modifications.

Immediately upon receipt of the Owner's acceptance letter, the Closing Coordinator will contact the mortgagee, mortgagee's counsel, Owner and Owner's counsel, OGC and representatives of Claims and Note Servicing to schedule a closing coordination call. The closing coordination call allows the parties to discuss closing requirements, timing, issues and logistics. It also allows OGC's Counsel to coordinate the timing for submission of draft closing documents with the mortgagee's attorney.

The Closing Coordinator will also immediately contact the HUD Project Manager to obtain copies of the following documents for inclusion in the Claims Package for PPCs:

- A. The existing insured Mortgage Deed and Mortgage Note;
- B. The Modification Agreement/Allonge (if any);
- C. The Original Closing Memo 290;
- D. The existing Regulatory Agreement;
- E. The existing Use Agreement (LURA), if any; and
- F. Any relevant waivers.

The total amount of a PPC will be finally determined by the certification of mortgage balance (Certification) from the servicing mortgagee after the application of remaining net cash proceeds and all unapplied funds. The Certification should include all escrow balances and must be signed by the mortgagee and the Owner.

Working with OAHP, the Claims Branch will verify the current unpaid principal balance (UPB) of the first mortgage and calculate the mortgage interest owed from the date of the last payment to the date of closing. The Claims Branch calculations are based on a 365 or 366 (leap year) day

year, and this may cause disparities in the interest calculations of HUD and the mortgagee. Five calendar days prior to closing, OAHP will provide to the Claims Branch a Closing Memorandum detailing the application of the claim payment to interest and principal. As part of the Closing Memorandum, a Sources and Uses Statement will be attached.

14-20. REQUIRED LEGAL CLOSING DOCUMENTS AND REVIEW

The following HUD Forms will be submitted by the new or continuing mortgagee to the Closing Coordinator for inclusion in the Claims Package in the case of a PPC:

- A. 2537 Mortgagee's Application for Partial Settlement;
- B. 2747 Application for Insurance Benefits;
- C. 1044-D Payment Information Treasury Financial Communication System;
- D. Payment Authorization to a third party (third party to complete 1044-D if appropriate);
- E. Notice of Default (MDDR);
- F. Certification of Mortgage Balance signed by original mortgagee and Owner; and
- G. Sources and Uses statement signed by new mortgagee and Owner.

At least 15 business days prior to the closing date, the Owner must submit, in an acceptable format, a full set of the required legal documents to the OGC Counsel in Headquarters assigned to the case. Failure to do so will delay the closing. (Sample versions of the documents may be obtained from the assigned attorney in OGC/HQ upon approval of the PPC or Restructuring.) These documents include but may not be limited to the following:

- A. Modification of First Mortgage/Deed of Trust Note and First Mortgage/Deed of Trust;
- B. Modification of Security Agreement;
- C. Second Mortgage/Deed of Trust Note (for PPCs or Restructurings);
- D. Second Mortgage/Deed of Trust (for PPCs or Restructurings);
- E. Subordination of any additional liens;
- F. Amendment to Regulatory Agreement;
- G. Second Regulatory Agreement for PPC mortgage;
- H. UCC Financing Statements;
- I. Title Endorsements and Commitments and a new Title Policy for the second PPC or Restructuring Mortgage;
- J. HUD Use Agreement;

-
- K. Good Standing Certificate of Borrower;
 - L. Attorney's Certification to HUD confirming No Change to Documents; and
 - M. Escrow Instruction Letter.

14-21. CLOSING PROCESS

Upon receipt of all documents for Claims, the Closing Coordinator will prepare a memorandum for the Multifamily Claims Branch based on the Sources and Uses and model. This will serve as the cover letter for the submission of all the documents referenced as claims documents above. The Closing Coordinator will confirm with OGC Counsel that all comments regarding the legal documents have been addressed and the transaction is ready to close.

Upon receiving notification from the Closing Coordinator that the transaction is ready to close, the mortgagee's attorney will prepare the final loan closing documents and obtain borrower's and mortgagee's signatures. The borrower and mortgagee must execute the documents before they are submitted to OAHP for signature. If OAHP is expected to forward the documents to a title company or other party for closing, proper mailing media (i.e., an overnight service envelope with an addressed bill of lading) shall be included with the documents submitted for signature.

For a PPC or Restructuring, on the day of closing, once the title insurance company confirms to OGC that it is in a position to comply with the Escrow Instruction Letter, the mortgagee's attorney will notify OAHP and OGC and the claim payment wire transfer can be triggered. All parties must be made aware that there is no guarantee that the PPC or Restructuring payment will be received in escrow the day the wire transfer is triggered, and should plan accordingly. The mortgagee's attorney shall forward scans by email of the original PPC or Restructuring Note for the second mortgage in HUD's favor and the second PPC or Restructuring Mortgage submitted for recording to OAHP on the day of closing. The original notes for the second mortgages shall be sent for receipt by OAHP the day after the closing.

Section 7. POST CLOSING REQUIREMENTS

As soon as documents are available after closing, the PPC or Restructuring Note must be delivered by OGC or OAHP to the Office of Multifamily Notes Servicing. A copy of the recast first note and mortgage must also be provided by OGC or OAHP to the Office of Multifamily Insurance Operations, to ensure that MIP is properly calculated post closing. In addition field staff should confirm removal of default flags after closing has occurred.

The fully executed closing documents, along with supporting documentation showing compliance with all the terms and conditions of approval must be submitted to the Headquarters' Office of the General Counsel. One copy of the documents must be sent to the Director of the project's Multifamily Hub, and one copy to the Director, Office of Asset Management at HUD Headquarters. The closing documents and required certifications are to be submitted in the form prescribed by HUD Counsel and signed by the Owner's counsel, as appropriate.

As long as the PPC or Restructuring Note is held by HUD, OAHP's Portfolio Management Office will work with the Project Manager to compare the Annual Financial Statement submitted by the Owner to the final HUD-approved baseline and 10-year projections. Significant deviations should be investigated to ensure all income and expenses, reserves and accounts payable are properly accounted for and that surplus cash is accurate. An example of an improper practice would be running the cost of a replacement reserve item through expenses, rather than requesting a withdrawal from the reserve. This will have the effect of inflating expenses and reducing surplus cash, of which 75 percent must be paid on the second mortgage. Expenses should also be closely examined to ensure that no expenses related to the PPC or Restructuring have been incurred, as these are disallowed. All accounting, legal, and consultant fees must be paid for by the Owner and not out of project accounts.

After completion of the financial statement analysis, the Project Manager is required to summarize the analysis in iREMS. This must be completed annually as long as HUD is the holder of the PPC or Restructuring mortgage.

The Project Manager should follow established protocol to ensure filing of accurate financial statements and that required payments are made on the PPC or Restructuring Note.

APPENDIX A

MORTGAGEE LETTER 87-9

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

February 20, 1987

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

Mortgagee Letter 87-9

TO: All Approved Mortgagees

SUBJECT: Mortgage Prepayment Provisions For HUD-Insured and
Coinsured Multifamily Projects

This Mortgagee Letter supersedes Mortgagee Letter 87-4,* dated January 12, 1987, in its entirety. (The format of this letter is the same as that of Mortgagee Letter 87-4; note, however, that substantive or clarifying changes have been made to the following paragraph and Sections I-A(2), I-C(1), II-A and II-B.)

This letter clarifies HUD's position with respect to the inclusion of provisions prohibiting partial or full prepayments ("lock-outs") and prepayment penalties in fully-insured and coinsured project mortgages. The policies set forth below apply to all project mortgages endorsed for full insurance under Section 207, 213, 220, 221(d)(3) or (d)(4), 223(f), 231, 232, 241 or 242 of the National Housing Act, or endorsed for coinsurance under Section 221(d) or 223(F) of the National Housing Act on or after the date of this letter, except those mortgages which are funded with the proceeds of State or local bonds sold prior to January 12, 1987.

I. Basic Policy

- A. Mortgages funded with the proceeds of tax-exempt or taxable bonds-issued by State or local governmental bodies may include the following, so long as the conditions cited in Section II below are met:

(1) a lock-out provision with a maximum term of ten years plus the construction period stated in the construction contract, if any; and

(2) a penalty provision applicable to prepayments made after the lock-out period, provided the penalty:

-- would not exceed five percent during the first

year following the lock-out period,

-- would decline on a graduated basis (to the extent practicable, the decline in the penalty percentage should be the same each year), and

* Note: Mortgagee Letter 87-4 was not fully distributed.

2

-- would be no higher than one percent by the end of the fifth year following the lock-out period.

B. Mortgages funded with the proceeds of GNMA mortgage-backed securities or other bond obligations (as defined below) may include the following, so long as the conditions cited in Section II below are met:

(1) a lock-out provision with a maximum term of ten years plus the construction period stated in the construction contract, if any; or

(2) a prepayment penalty that would be no more than one percent at the end of the tenth year following the construction period stated in the construction contract (if the initial penalty is three percent or less and the penalty meets the other limits enumerated in paragraph C(2) below, the conditions of Section II need not be met); or

(3) a combination lock-out/penalty provision with a lock-out period of less than ten years and a penalty that would be no more than one percent at the end of the tenth year following the construction period stated in the construction contract.

NOTE: For purposes of this Category B, "other bond obligation" refers to any agreement under which the Insured mortgagee has obtained the mortgage funds from third party investors and has agreed in writing to repay such investors at a stated interest rate and in accordance with a fixed repayment schedule.

C. All other mortgages:

(1) may not include any lock-out provisions other than prepayment prohibitions required by HUD regulations (e.g., 24 CFR, Section 207.32a(e)(2), 231.12(a), or 255-503(i)); but

(2) except for Section 241 mortgages of \$200,000 or less, may include a prepayment penalty provision, so long as the penalty:

-- would not apply to any prepayments which, in any calendar year, do not exceed 15 percent of the original mortgage amount,

-- would not exceed three percent during the first year of the mortgage term unless the conditions cited in Section II below are met, in which case, the initial penalty could be set as high as ten percent,

3

-- would decline on a graduated basis (to the extent practicable, the decline in the penalty percentage should be the same each year), and

-- would be no higher than one percent by the end of the tenth year following the construction period stated in the construction contract.

II. Conditions for Inclusion of Lock-outs and/or Penalties

We will allow lock-outs (Category A or B mortgages) or prepayment penalties that initially exceed three percent (Category A, B, or C mortgages) only when the conditions noted below are met.

- A. For both full insurance and coinsurance cases, the following language, allowing HUD to override the lock-out and/or prepayment penalty provision in the event of a default in order to facilitate a refinancing or partial prepayment of the mortgage and avoid an insurance claim, must be included in the mortgage note:

Notwithstanding any prepayment prohibition imposed and/or penalty required by this Note with respect to prepayments made prior to _____, 19__, [enter first date on which prepayments may be made with a penalty of one percent or less] the indebtedness may be prepaid in part or La full without the consent of the mortgagee and without prepayment penalty if HUD determines that prepayment will avoid a mortgage insurance claim and is therefore in the best interest of the Federal Government.

HUD would consider exercising an override of a mortgagee's prepayment lock-out and/or penalty provision only if:

4

- (1) the project mortgagor has defaulted and HUD has received notice of such default, as required by 24 CFR Section 207-256 (full Insurance cases) or Section 251.810 or 255.808 (coinsurance cases);

-
- (2) HUD determines that the project has been experiencing a net income deficiency, which has not been caused solely by management inadequacy or lack of owner interest, and which is of such a magnitude that the mortgagor is currently unable to make required debt service payments, pay all project operating expenses and fund all required HUD reserves;
 - (3) HUD finds there is a reasonable likelihood that the mortgagor can arrange to refinance the defaulted loan at a lower interest rate or otherwise reduce the debt service payments through partial prepayment; and
 - (4) HUD determines that refinancing the defaulted loan at a lower rate or partial prepayment is necessary to restore the project to a financially viable condition and to avoid an insurance claim.
- B. For full insurance cases only, the mortgagee must certify at initial endorsement (final endorsement, in insurance upon completion cases) that, in the event of a default during the term of the prepayment lock-out and/or penalty (i.e., prior to the date on which prepayments may be made with a penalty of one percent or less), it will:
- (1) request a three-month extension of the deadline prescribed by 24 CFR Section 207.258 for filing a notice of its intention to file an insurance claim and its election to assign the mortgage;
 - (2) if HUD grants the requested (or a shorter) extension of the notice filing deadline, assist the mortgagor in arranging a refinancing to cure the default and avert an insurance claim;
 - (3) report to HUD at least monthly on any progress in arranging a refinancing;
 - (4) otherwise cooperate with HUD in taking reasonable steps in accordance with prudent business practices to avoid an insurance claim; and
 - (5) require any successor's or assigns to certify in writing that they agree to be bound by these conditions for the remainder of the term of the prepayment lock-out and/or penalty.

5

The above certification must be incorporated by reference into the Mortgagee's Certificate.

In the event of a default, HUD would determine whether to

grant the three-month (or shorter) extension of the election notice filing deadline based on its analysis of the project's financial condition and its assessment of the feasibility of arranging a successful refinancing. No further extension of the election notice filing deadline would be considered by HUD, unless an additional extension were specifically requested by the mortgagee.

III. For Further Information

Questions concerning this letter should be directed to the Insurance Division, (202)755-6223, or the Coinsurance Division, (202)426-7113, of the Office of Insured MultiFamily Housing Development.

Sincerely yours,

Thomas T. Demery
Assistant Secretary
U.S. Department of Housing and Urban Development
Washington, D.C. 20410-8000
July 31, 1987