



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

WASHINGTON, DC 20410-8000

OFFICE OF HOUSING

MEMORANDUM FOR: All Multifamily Hub Directors
All Multifamily Program Center Directors
All Multifamily Operations Officers

FROM: Theodore Toon, Director, Multifamily Development, HTD

SUBJECT: FHA Low Income Housing Tax Credit Pilot Program Revisions

The FHA Low Income Housing Tax Credit (LIHTC) Pilot was created in 2011 to better align FHA's underwriting process with the timing constraints of LIHTC projects, to increase FHA's affordable housing production and preservation and to test the Single Underwriter operating model. There are now 37 qualified MAP Lenders, 9 Pilot Hubs with specially trained Pilot underwriters, nearly 100 deals with 10,000 units in the pipeline, and 20 closed projects. As HUD has gained and evaluated its experience with the Pilot, Multifamily has identified several points to be clarified and several policy adjustments needed to standardize our practice and expand production.

The policy adjustments described below are intended to provide more flexibility to the Pilot and make it available to a wider array of projects. The areas to be addressed in this memorandum are all a function of guidance (MAP Guide, Notices and Mortgagee Letters, etc.), and therefore require no regulatory waivers or statutory changes. They fall into two categories: The first six elements, in Part I, are policy changes effectuated by this memorandum, and to be subsequently incorporated into the MAP Guide. Waivers will be required to implement each of these changes for individual transactions until such time as the policy changes are published more formally in the MAP Guide later this year. Hub Directors have the authority to sign off on these waivers, and should be favorably inclined to do so subject to the conditions and mitigants outlined below. For each of these waiver types, Appendix 2 of this memo specifies the appropriate section of the MAP Guide and/or other relevant guidance, which should be cited in each waiver request (HUD-2 form). Approved waivers are to be uploaded to the designated HUD 2 SharePoint site at the following address:

<http://hudsharepoint.hud.gov/sites/DASMFH/OMHD/Lists/Hub%20Level%20Waivers/Standard.aspx>

The remaining six elements described in Part 2 of this memorandum are simply clarifications of existing policy: As such they will not require waivers, and they too will be incorporated into the MAP Guide.

We will continue to look for opportunities to better align FHA products, policies and processing with LIHTC transactions, balancing alignment with our responsibility to manage risk. We intend to expand the LIHTC Pilot to the broader MAP platform as the Pilot proves out the potential for this way of business. We will be seeking your feedback and that of stakeholders in the year to come to better understand how best to achieve these goals.

PART I: POLICY CHANGES WITH WAIVER REQUIREMENTS

1. Total Debt Load Allowed Under 223(f): Current, long-standing 223(f) policy, though not statutory or regulatory, limits total debt load on a property to 92.5% of appraised value. FHA's definition of "total debt" has included the FHA-insured 223(f) loan plus any subordinate debt, including seller take-back notes, deferred developer fees converted to debt, and other partner debt, but excluding subordinate debt issued by a public source. HUD will continue to enforce the LTV and DSCR requirements of the 223(f) program for sizing the first mortgage at an 85% loan ratio for Tax Credit projects. (The 92.5% only applied when other debt was included.) However, for all future Tax Credit projects HUD will remove the 92.5% limit on total debt and allow subordinate sources, when combined with the first mortgage, to exceed 92.5% as long as that subordinate debt meets all of the following conditions:

- a) The debt is "soft" cash flow debt, i.e., only payments from surplus cash, if available, can be required;
- b) Any such payments required under the note(s) may not exceed 75% of surplus cash;
- c) The debt is documented in a promissory note;
- d) The debt is not secured with a lien against the property or evidenced by any recorded instrument; and
- e) The debt is subject to automatic resubordination in any subsequent refinancing of the first mortgage.

Balloon payments on subordinate debt prior to maturity of the FHA-insured first mortgage are generally prohibited, but may be considered on a case by case basis when the issuer/holder of the subordinate debt is a nonprofit or public entity.

2. Three Year Waiver Transactions: The 223(f) program is limited to existing projects, defined by HUD as "...originally completed or substantially rehabilitated less than 3 years prior to the date of application for the Firm Commitment." HUD has issued Mortgagee Letters over the past several years waiving this "3 year rule" for 223(f) LIHTC transactions, to provide relief to projects coming out of construction but unable to secure other sources of permanent financing. The latest Mortgagee Letter providing this waiver authority will expire on September 18th, 2014. However, the uncertainty of permanent financing still hinders LIHTC construction starts. Under current practice a Firm Application must have been submitted prior to this deadline. Under this memorandum, HUD is adjusting the time at which the clock starts under the current Mortgagee Letter to allow eligible Pilot projects with building permits obtained before the current Mortgagee Letter expires, to be "grandfathered" and remain eligible for a 3 year rule waiver. This enables borrowers submitting Tax Credit deals that meet the amended timing to apply for 223(f) through the Pilot upon completion.

This change will broaden the pool of properties eligible for the Pilot under the 3 year rule waiver, but will limit the pool to a finite group of properties that have secured permits before the deadline. Furthermore, as noted in Mortgagee Letter 2012-13, all of the requirements of the original waiver will apply to these projects, except for the requirement for applicants to provide evidence of unsuccessful attempts to secure other permanent financing.

3. IOI and Mortgage Calculations: When there is an Identity of Interest between the buyer and seller, the MAP Guide requires treatment of the transaction as a refinancing (under criterion 10) rather than an acquisition (under criterion 7). This limits mortgage proceeds to 80% of value rather than 85% of value for LIHTC transactions (or 87% if there is a Project based Section 8 contract covering at least 90% of the units). Many LIHTC transactions involve a transfer in which at least one party remains in the transaction. All LIHTC refinancing transactions involving transfers of title, whether to an Identity of Interest entity or an arm's length party, will be treated as an acquisition rather than as a refinance. They will therefore be allowed to go up to the full 85% (or 87%) LTV. Please note that this policy applies to all Section 223(f) loans within or outside of the Pilot Program, so long as the projects meet the affordability definition in the MAP Guide.

4. Completion Assurance: The LIHTC Pilot, using 223(f) financing, has required a non-mortgageable Assurance of Completion Escrow in the amount of 20% of the rehabilitation cost in addition to the estimated non-critical repair costs. The Assurance of Completion Escrow may be used as a construction contingency at any time (contingencies are otherwise not a part of the 223(f) program), and it can be provided in the form of an irrevocable LOC or in cash. LIHTC borrowers frequently request and are granted reductions from 20% to 10%. This is appropriate in cases with relatively simple or clearly defined scopes of work and repair cost analyses, sufficient oversight of the construction, and/or non-mortgageable reserves. Other mitigants to justify reduced funding might include factors such as an architect on the job, use of plans and specs for any complex work, use of General Contractors and fixed sum contracts, etc. HUD intends to change the LIHTC Pilot policy in the MAP Guide to make 10% the standard requirement, with discretion to increase it if the scope of work and total cost suggest a need for additional protection. In the meantime waivers are to be treated favorably and approved by the Pilot Hub Directors. This provision applies to Pilot projects only.

5. Timing of Repair Escrow Funding and General Equity Pay In Schedule: The LIHTC Pilot has required 100% of Non-Critical Repair Costs to be funded at closing: Because a 223(f) loan is fully funded and insured at closing, HUD has considered it important for other capital sources to be at least partially funded at closing as well. However, rehab in LIHTC transactions is often funded with a combination of equity and FHA debt, so this requirement forces owners to call equity early or secure a bridge loan to fully fund the escrow at closing. The problem is exacerbated in projects with high acquisition costs and in refinancings with high existing debt that must be repaid at closing. HUD has waived the requirement when it had a demonstrated, material cost impact, when deferred funding was mitigated by high borrower liquidity, when the escrow disbursement agreement allowed for *pari passu* installment payments on construction along with an equity pay-in schedule matching that draw schedule, and/or when the borrower provided a guaranty of timely funding of the rehabilitation.

HUD will continue to allow for a gradual pay-in of equity, including the equity needed to fund the repair reserve, provided that two conditions are met:

- a) At least 20% of the total project equity (syndication proceeds) must be paid in at closing, and
- b) A disbursement agreement is provided by the lender and approved by HUD, specifying that the rehab escrow, including loan proceeds and initial equity remaining after closing and acquisition, and subsequent equity installments, is disbursed in approximate *pari passu* proportions.

6. Tax Credit and Bond Cap Allocation Timing: The Pilot Notice and Mortgagee Letter have required the owner to have its 9% Tax Credit Allocation (or Bond Cap Allocation, in the case of 4% Credits) in hand at the time of application for the Pilot. This has not proven practical given states' widely variable timing and in some states, the short lifespan of such allocations. Accordingly, HUD prefers evidence of the allocation as part of the Pilot application package, but Hub Directors can waive the requirement, and accept the application subject to the owner securing its allocation prior to Firm Commitment, or in some cases (and some states), Hub Directors may waive this requirement and issue a Firm Commitment with a condition that the owner secure its allocation prior to closing. In issuing waivers, Hub Directors should consider the risk of devoting staff time to underwriting before an allocation is certain, and the likelihood the allocation will be secured, based on sponsor experience, etc. The proposed borrower should also be advised in the Concept Meeting that the FHA application fees will not be refunded if a project has been reviewed by HUD and subsequently fails as a result of failure to obtain a final allocation.

PART. II CLARIFICATIONS OF POLICY

7. Clarification of FHA Lenders' Underwriting Requirements for Syndicators and Principals.

A more detailed discussion of lenders' assessments of syndicators and principals in tax credit transactions is attached for immediate use and will be integrated into the revised MAP Guide. HUD expects that lenders will collect and analyze data regarding the qualifications, both experience and financial capacity, of syndicators/investors for review by FHA Underwriters, following review standards similar to those used elsewhere in the industry, as described in Attachment 1. HUD prefers this due diligence from the lender as part of the Pilot application package, but because transactions do not always have a syndicator locked in at application, Hub Directors can accept the application subject to submission of its syndicator review prior to Firm Commitment, or in some cases, Hub Directors may issue a Firm Commitment with a condition that the owner secure its allocation prior to closing. Hub Directors should consider the risk of devoting staff time to underwriting before a syndicator is identified and reviewed, and the likelihood a syndicator will be secured based on sponsor experience, etc.

8. Tax Abatements. Industry partners have pointed out that HUD offices are inconsistent in granting waivers when calculating NOI when a tax abatement is available to the property in question. While this inconsistency may sometimes be appropriately responsive to the varying forms of tax abatements we see, which can vary greatly by state and municipality, greater guidance will be helpful to achieve greater consistency relative to similar fact patterns. HUD will recognize the abatement in both the value and in NOI calculations for Tax Credit transactions in any FHA program (per a MAP Guide FAQ, Chapter 7, #5, issued 5/22/03), even if the abatement runs with the owner rather than with the land, so long as the owner is nonprofit sponsored. Other mitigants such as lower than maximum loan to value ratios or significant rent advantages must also be in place, but no waiver is required. The Hub Director has the authority to apply this treatment, considering circumstances that may be a specific to jurisdiction's tax abatement structure.

9. Use of Form 2530. These 2530 forms are no longer required for Tax Credit syndicators, investor members of LLCs, investor partners of limited partnerships or any other passive partners, even in the case of an Identity of Interest. HUD has issued guidance on this issue, and now for Tax Credit projects, 2530s are not required as long as the Tax Credit Syndicator's identity of interest is not with the General Partner.

10. Pre-Approval of Special Limited Partners. Investors sometimes need notice and cure rights, and the right to bring in a “Special Limited Partner” quickly in case of default or other failure of the initial General Partner. HUD has established a process through which a substitute general partner may be approved in advance at closing, to avoid delays if a general partner fails to fulfill its responsibilities. The pre-approval of a Special Limited Partner to step in and act as a General Partner for a limited period of time, under specific conditions, has been addressed in a new “Rider to the Security Agreement for LIHTC Properties” prepared by OGC to address this concern. The process does require submission of 2530s since the substitute would not be a passive partner. HUD has also determined that while replacement of passive partners will not require 2530s, it will require a modified Transfer of Physical Assets (TPA).

11. Due Diligence with Respect to Nonprofit Boards. 2530s are required only for board officers and not board members, and neither personal financial statements nor credit checks are required for regular board members or the officers of the board.

12. Building Permits: Building permits should be required only in time for closing for all Tax Credit projects. Firm Commitments can be issued with conditions requiring building permits prior to closing. The lender/borrower bear the risk that permits are not secured timely, requiring updating of due diligence materials, etc.

These changes are to become effective immediately through this memo to the field, but they will also be communicated to MAP lenders through usual channels including web posting, transmittal to MBA, etc., and subsequently incorporated into the new MAP Guide. Please contact Lynn Wehrli with any questions, at 202 402-5210 or lynn.wehrli@hud.gov.

ATTACHMENT I

Underwriting Guidance for Tax Credit Syndicators and Principals

Syndicators are entities that organize tax credit transactions by identifying and screening potential projects, conducting due diligence with respect to those projects, structuring the transactions and negotiating with the owners/developers, pricing the investment and obtaining investors to participate. Syndicators may establish funds for multiple projects, or they may syndicate single projects. They generally have an ongoing role and management function throughout the life of the project by providing asset management services, ensuring that investors' tax related documents are provided to investors by the project management, state allocating agencies and the entities operating the projects, etc. In some cases syndicators also create a related party entity that serves as a general partner or managing member of the ownership entity.

Tax projects use either limited partnership (LP) or limited liability company (LLC) business structures. For FHA underwriting purposes, in limited partnerships the principals include all general partners, as well as any limited partners who own a 25 percent or greater interest in the partnership. In limited liability companies principals include all managing members, as well as any investor members who own a 25 percent or greater interest. In LIHTC transactions, the investor limited partner or investor member generally has a 99% or greater ownership interest and therefore qualifies as a principal. Finally, it is important to note that the primary documentation of the structure of the ownership entity is a limited partnership agreement in the case of an LP and an operating agreement in the case of an LLC and review of these documents is a critical element of the underwriting of the project.

The partnership agreement or operating agreement often provides the investor partner the right to replace the general partner or managing member in certain circumstances with a third party (commonly a special limited partner or managing member), or to step into that role. Accordingly it is important for a lender to obtain the information necessary to ensure that the substitute entity also has the capacity to operate the project if necessary. HUD will accommodate early approval of the substitute entity through the 2530 clearance process and adaptation of closing documents for tax credit transactions, so as to avoid delays when a general partner or managing member has to be replaced.

The Lender must perform an overall risk assessment of the ownership entity and its principals as identified above, taking into consideration the specifics of the transaction. In all cases the Lender must obtain and analyze any information that it determines necessary to complete an appropriate credit review, including all of the following:

1. Organizational structure described in narrative and organizational chart form;
2. Description of multifamily business experience and qualifications;
3. General credit history; and
4. Current and prospective financial condition.

The lender's conclusions regarding financial strength, experience, qualifications, character and credit history must also address the size, complexity, structure and risks of the transaction.

The following information with respect to the investment fund and the individual investors should also be obtained and reviewed by the lender when underwriting a tax credit transaction:

1. Syndicator's Fund Level Financials and Other Information. These should be reviewed in order to:
 - a. Confirm that the equity and reserves are going to be there if needed;
 - b. Determine whether or not the fund is committed to the project under review;
 - c. Ascertain the size of the fund;
 - d. Determine the number of investors and the commitment level of each. (Generally, syndicators will not disclose who the individual investors are, which is reasonable as this is proprietary.)
2. Identify all of the principals (from the organizational structure analysis above) and find out whether or not there are financials for them. Sometimes these are just shell entities but the particular organizational structure being used may require this information to be reviewed.
3. Identify the entity that a syndicator/investor would put in as GP or Managing Member if the original entity had to be replaced.
 - a. Note that in analysis of this entity, capacity and experience is more important than financial strength because it may take over control of the borrower. Generally speaking, this can be a sensitive topic since it will be an affiliated entity and its employees will be carrying out this function. While names may not be provided, the number of people and their experience levels are relevant.)
 - b. The syndicator should be able to provide a summary of the number of deals the entity has stepped into over the past 5 to 10 years, and a summary of the outcome of those substitutions is also useful.

ATTACHMENT 2: Guidance to be Cited in Form HUD 2 for Waiver Requests

1. Requests for waivers of the 223(f)s Maximum Loan to Value ratio are to reference the following:
 - a) Multifamily Accelerated Processing (MAP) Guide, Revised November 23, 2011, "Secondary Financing" Section 8.9.B.1.b., page 236
2. Requests for waivers of the "Three Year Rule" are to reference the following:
 - a) MAP Guide, "Section 223(f) Acquisition/Refinancing of Existing Apartments", Section 3.9.A. Eligible Properties, and
 - b) Mortgagee Letter 2013-31, September 18th, 2013.
3. Requests for waivers of treatment of IOI projects as acquisitions rather than refinancings are to reference the following:
 - a) MAP Guide, "Section 223(f) Acquisition/Refinancing of Existing Apartments", Section 3.9.
 - 1) Second introductory paragraph on page 55, and
 - 2) Section 3.9.I., Criteria 7 on page 57, and
 - 3) Section 3.9.I., Criteria 10 on page 58.
4. Requests for waivers of the 20% Completion Assurance requirement.
 - a) MAP Guide, "Section 223(f) Acquisition/Refinancing of Existing Apartments", Section 3.9.C.2. (Note this language in the MAP Guide refers to 120% of the cost of repairs, which includes the 20% for Completion Assurance addressed in this memo.)
5. Request for waivers of 120% funding of repair escrow and Completion Assurance.
 - a) MAP Guide, "Section 223(f) Acquisition/Refinancing of Existing Apartments", Section 3.9.C.2. (Note this language in the MAP Guide refers to 120% of the cost of repairs, which includes the 20% for Completion Assurance addressed in this memo.)
6. Requests for waivers of the Pilot Program requirement that Tax Credit allocations are to be submitted at the time of application.
 - a) Notice 2012-1, Multifamily Low Income Housing Tax Credit Pilot Program, February 3, 2012, PART IV.B., Eligible Projects and Loan Amounts.