



U.S. Department of Housing and Urban
Development

Office of Housing

Special Attention of:

Regional Directors,
Field Office Directors,
Multifamily Hub Directors,
Multifamily Program Center
Directors, Housing Project
Managers, Section 202 Owners and
Management Agents

Notice H 04-21

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Subject: Amendments to Notice H2002-16: Underwriting Guidelines for Refinancing of
Section 202 and 202/8 direct loan prepayments.

Table of Contents:

<u>SECTION</u>	<u>TITLE</u>	<u>PAGE</u>
I.	PURPOSE.....	
II.	AUTHORITY.....	
III.	MORTGAGE INSURANCE PROCESSING.....	
IV.	DEVELOPER'S FEES AND SURPLUS DISTRIBUTION.....	
V.	UNDERWRITING USING RISK-SHARING.....	

I. PURPOSE.

This Notice amends Notice H 2002-16. “Revised Prepayment of Direct Loans on Section 202 and 202/8 Projects with inclusion of FHA Mortgage Insurance Guidelines.” Articles VIII and XVII of Notice H 2002-16 are amended with the underwriting provisions in this Notice.

The primary purpose of this Notice is to provide revised underwriting guidelines for processing FHA multifamily mortgage insurance in the refinance of Section 202 direct loans. The second purpose is to revise the maximum developer’s fee and to revise the limits on surplus distribution. This Notice also adds provisions on mandatory meals and property tax abatement. The revisions herein apply only to Section 202 direct loan refinancings, and apply to both Multifamily Accelerated Processing (MAP) and Traditional Application Processing (TAP).

The goal of these revisions is to make FHA mortgage insurance financing more available to sponsors of Section 202. Without these underwriting changes, very few refinancings of Section 202 and 202/8 will be able to be completed. The primary change is to permit the rents to be underwritten at contract (Section 8 or other rental subsidies) rental rates. Heretofore, rents had to be underwritten the lower of contract rental rates or market rates. Changes are also made in Section 223(f) loan-to-value ratio and debt service coverage.

Except as explicitly amended in this Notice, Housing Notice H2002-16 remains in effect.

II. AUTHORITY.

Housing Notice 2002-16, in Article II, describes the statutory authority for prepayment of Section 202 and 202/8 loans. Article III of the Notice H 2002-16 states that there is no requirement that a Section 202 or 202/8 include FHA mortgage insurance.

However, HUD’s FHA multifamily mortgage insurance programs, or its risk-sharing programs under Section 542 of the Housing and Community Development Act of 1992, may be use to facilitate the prepayment/refinancing of Section 202 or 202/8 Direct Loans. The project sponsor and HUD-approved Lender, or the Housing Finance Agency or Qualified Participating Entity, may submit the application for mortgage insurance or the request for a Risk-Sharing Firm Approval letter or Risk-Sharing Addendum at the same time a request for prepayment proposal is submitted to the Hub or Program Center.

Authority for refinancing using FHA Mortgage Insurance is provided in the National Housing Act (NHA), as amended, with specific reference to Sections 221(d)(4) and 221(d)(3) for substantial rehabilitation and Section 223(f) for purchase or refinancing of apartments. Authority for risk-sharing is covered in Article V, below.

III. MORTGAGE INSURANCE PROCESSING UNDER THE NATIONAL HOUSING ACT

Many Section 202 projects are assisted with Section 8. Some of the Section 202 projects are assisted by Rental Supplements or other rental subsidy. The phrase “Section 8” as used in this Notice refers as well to Rent Supplements and other rental subsidies.

Recognizing the special needs required under the Section 202 program, the Department hereby revises FHA Mortgage Insurance underwriting instructions for all Sections of the Act as outlined below:

- A. Transactions with project-based Section 8 Contracts:
 - 1. Follow Handbook 4465.1 “Valuation Analysis” and the MAP guide for completing the market rent analysis. Unassisted units within the project, if applicable, shall be processed at market rent. The processing rents used for the project-based Section 8 assisted units will be the current or to be adjusted Section 8 contract rents for the project, even if the contract rent is in excess of the market rent.
 - 2. In the absence of sales of assisted properties with which to draw a comparison, capitalization rates may be derived using a band of investment and the Section 8 contract and any favorable financing specific to the application may be factored into the rate analysis.
- B. The debt service coverage ratio for 223(f) applications shall be processed at 1.1. The debt service coverage ratio for 221(d) applications remains unchanged at 1.1 for Section 221(d)(4) and 1.05 for Section 221(d) (3).
- C. Loan to value for 223(f) applications may be processed at 90%. The maximum loan for a Section 221(d)(4) remains at 90% of the sum of HUD estimated cost of repair and rehabilitation and the as-is value of the property. For a Section 221(d)(3), the maximum loan is 100% of the estimated cost of repair and rehabilitation and the as-is value of the property.
- D. The appraised value, if applicable, must be based on market rents unless the project has Section 8 contract rents or another rental supplement. Contract rents are applicable only to those units with rental subsidy. The following comparables may not be used:
 - 1. Upscale retirement service centers with amenity packages included in the rent; or

2. Projects with up-front entrance or founders fees or life-care fees.

Note: Rent analyses performed under the current Section 8 rent comparability contract renewal guidelines have no bearing on FHA mortgage insurance processing.

C. Property Tax Underwriting

With respect to the Section 202 refinancing which is the subject of this Notice, the underwriter may assume that any current property tax exemption or proposed property tax exemptions may be extended for the term of the refinanced loan, provided that the mortgagor is a non-profit organization that has been, or will be granted exemption by local or state government from property taxes for the term of the loan. For shorter-term abatements, follow the instructions below. It is preferable if the exemption also runs with the property, but if that is not the case, the exemption can run with a bona-fide non-profit sponsor who is expected to be the mortgagor for the term of the abatement. Property taxes are abated only to the extent permitted by local or state law. Proof of existence of a tax abatement will be evidenced by a letter from the local tax assessor describing the project, nature of ownership entity, and length of the abatement.

1. Long Term Tax Abatement

If the amount of the tax abatement is fixed and runs the entire term of the mortgage, the real estate tax expense reported on the HUD-92264 must be the actual amount of the taxes the property will pay. The full amount of the real estate taxes without the abatement must be noted in the remarks section of the HUD-92264. The property will benefit from an increased mortgage amount due to the lower pro-forma operating expenses and an increased NOI estimate. Note: when the abatement covers the full term of the mortgage, the NOI used for Form HUD 92264A, Criterion 5 may also be processed at the reduced tax amount.

2. Short Term or Variable Tax Abatement

If the abatement is short term or varied, it possibly may still be used to secure additional mortgage proceeds. The amount of the additional mortgage will be the amount that the abated taxes will amortize over the term of the abatement. A special amortization plan must be requested which has debt service payments that are increased by the

amount of additional net income generated from the abatement, over the agreed term of the abatement.

When processing a short term or varied abatement, the full amount of the property taxes will be estimated and included in the total project expenses on Form HUD-92264 as if there were no tax abatement. The additional debt service ability resulting from the abatement must be calculated on line I, Criterion 5 of HUD 92264A.

If Criterion 5, “Amount Based on Debt Service Ratio”, does not control the mortgage, then the short term or variable abatement cannot be used to secure additional mortgage proceeds due to statutorily controlled loan to value limitations.

- Short Term Abatements: Assume that property A has been awarded a 5-year tax abatement of \$5,000 per year. The interest rate on the loan is quoted at 7.5%. The FHA Mortgage Insurance Premium (MIP) is 0.5%. The amount of additional mortgage is calculated by dividing the annual abatement, \$5,000 by the applicable debt service rate (Principal, Interest, and MIP). In this example the debt service rate is 0.245455383.

$$\text{\$5,000} / .245455383 = \text{\$20,370 Additional Mortgage Amount.}$$

The mortgage amount based upon debt service, Criterion 5 of HUD 92264A would be increased by \$20,370 and a special amortization schedule would be requested with a debt service payment that is \$5,000 per year greater in years 1 through 5.

- Variable Abatements: Varied tax abatements are a little more complex to quantify, but are essentially calculated in the same manner. Assume that property B has been awarded a 15-year tax abatement. In years 1 through 5, the abatement is \$25,000; in years 5 through 10 the abatement is \$10,000; and in years 11 through 15 the abated amount is \$5,000. The interest rate on the loan is quoted at 7.5%; MIP is 0.5%. The amount of additional mortgage is again calculated as the amount that could be fully amortized by the varied payments over the fifteen-year period based on the financing terms as stated. The graph on the next page illustrates the calculation.

When there is more than one abatement amount and period, and the amounts decline, the abatement amount for each period may be found by subtracting the abatement amount of the next period. Period 1 will run 5 years, period 2 will run 10 years, and period 3

will run 15 years. Because all three periods begin amortization at the same point, or year 0, you must subtract the amount of the abatement for the next period to avoid double counting.

Abatement Period 1

\$25,000 minus \$10,000 (the amount of abatement in period 2) = \$15,000 for 5 years. The debt service rate for a 5 year term at 7.5% interest with 0.5% MIP is 0.245455383, Dividing \$15,000 by 0.245455383 indicates additional mortgage proceeds of \$61,111 attributable to period 1.

Abatement Period 2

\$10,000 minus \$5,000 (the amount of abatement in period 3) = \$5,000 for 10 years. The debt service rate for a 10 year term at 7.5% interest with 0.5% MIP is 0.147442123. Dividing \$5,000 by 0.147442123 indicates additional mortgage proceeds of \$33,912 attributable to period 2.

Abatement Period 3

\$5,000 minus \$0 (since there are no periods remaining) = \$5,000 for 15 years. The debt service rate for a 15 year term at 7.5% interest with 0.5% MIP is 0.116241483. Dividing \$5,000 by 0.116241483 indicates additional mortgage proceeds of \$43,014 attributable to period 3.

Adding the supportable mortgages from each of the abatement periods results in a total additional supportable mortgage of:

Period 1 =	\$61,111
Period 2 =	\$33,912
Period 3 =	\$43,014
Total =	<u>\$138,037</u>

\$25,000	(\$5,000)	Abatement Period 1 $\$25,000 - \$10,000 = \$15,000$ $\$15,000 / 0.245455 = \$61,111$		
\$20,000	(\$5,000)			
\$15,000	(\$5,000)			
\$10,000	(\$5,000)	(\$5,000)	Abatement Period 2 $\$10,000 - \$5,000 = \$5,000$ $\$5,000 / 0.147422 = \$33,912$	
\$5,000	(\$5,000)	(\$5,000)	(\$5,000)	Abatement Period 3 $\$5,000 - \$0 = \$5,000$ $\$5,000 / 0.116241 = \$43,014$

The mortgage amount based upon debt service, or Criterion 5 of HUD 92264A would be increased by \$138,037 and a special amortization schedule would be requested with debt service payment by \$25,000 per year in years 1 through 5; \$10,000 in years 6 through 10; and \$5,000 in years 11 through 15.

F. Meals Service

Housing Notice 92-34 and Final Rule published in the Federal Register (56 FR 42798) on August 29, 1991 effective September 30, 1991 prohibits central kitchens and provision of food service in elderly housing projects under any rental housing section of the National Housing Act, including Sections 223 (f) and 221(d) (3) and 221 (d) (4). The Hub Director may permit meals to be served in refinanced Section 202 projects if:

1. Meals were provided before September 30, 1991 and have been continuously provided since that date;
2. Income and expenses from the meal service are not included in the underwriting of the refinancing; and
3. The meals program has proved self-sustaining based on review by Asset Management staff of the project's financial statements.

G. Prohibition on Equity Take Out

The mortgagor will not be permitted an equity takeout. In the case of a purchase transaction, the seller will be limited to an equity take out of the lesser of the purchase price or the unassisted market value of the property.

IV. **DEVELOPER'S FEES AND SURPLUS DISTRIBUTION**

Section VIII B 1 (a) of Housing Notice H2002-16 is revised to read:

The maximum developer's fee shall be the lesser of 15 percent of the acceptable development cost, as defined by the respective State LIHTC program, or the maximum fee allowed by each State's LIHTC program.

A new VIII B 2 is added:

If LIHTC is not used as a source of equity, the limitation on maximum developer's fee is also 15 percent of acceptable development costs.

The present VIII B 2 becomes VIII B 3 and is revised as follows:

- A. The maximum annual distribution from surplus cash as defined by the regulatory agreement that may be taken is 6 percent of the owner's equity that was paid at the refinancing of the project. Other Government funds (i.e., HOME funds, CDBG funds, etc.) **will not** be considered owner's equity. LIHTC equity is not other Government funds.

V. **UNDERWRITING UNDER RISK-SHARING**

Underwriting the refinancing of Section 202 Direct Loans under risk-sharing is processed by Qualified Participating Entities under their own guidelines and their agreements with the Department of Housing and Urban Development and Section 542(b) of the Housing and Community Development Act of 1992. Underwriting the refinancing of Section 202 Direct Loans by state housing finance agencies under Section 542(c) of the Housing and Community Development Act of 1992 is governed by 24 CFR Part 266 "Housing Finance Agency Risk-Sharing Program for Insured Affordable Multifamily Project Loans," Section 24 CFR 266.200(d) requires the following:

The Section 542 mortgage amount must be based on the lower of:

- a. Current project-based Section 8 contract unit rents under rental agreements for other rental subsidies for the project; or
- b. Comparable unassisted market rents.

This Article V confirms and clarifies Article XVII, Section A.3. of Notice H2002-16.

John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner