



OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

December 23, 2003

MEMORANDUM FOR: All Multifamily Hub and Program Center Directors, All
Multifamily Operations Officers, Supervisory Project
Managers and Project Managers

FROM: Beverly J. Miller, Office of Asset Management HTG

A handwritten signature in black ink that reads "Beverly J. Miller".

SUBJECT: Risk Alert – Placing APPS Risk Flags and Reporting Requirements
Related to Mortgage Default and Financial Relief

FOR IMMEDIATE EFFECT AND ACTION

In today's interest rate climate, there is a great deal of pressure to refinance existing loans. Where there are no loan prepayment penalties and/or lock out requirements, owners are proceeding to take full advantage of historic low interest rates.

However, in many cases, penalties and prepayment lockouts make refinancing difficult, expensive or impossible. Under the terms of many existing mortgage notes, HUD can set aside lockouts and penalties where a default exists that will result in a claim paid from the FHA insurance fund (See Mortgagee Letter 87-9). Where there is a valid default, our action to set aside a lockout or other penalty enables the mortgagor to refinance and avoids the mortgage insurance claim. It also means an investor has lost a valuable investment, an asset that may not be replaceable in kind. Therefore, we must be sure that our action is related to a valid default. Before we set aside such lockouts/penalties we need to be very sure that a default is genuine. It is unfortunate, but rumors continue concerning various schemes¹ to "manufacture or contrive defaults" to evade or circumscribe the mortgage note's requirements regarding prepayment. By determining as part of our review the most likely cause(s) of the default, we can assure any of the

¹ In one alleged scheme, the investor is approached by another party and told that as the note is in default when it goes to FHA claims they will only receive par or par less the 1%. They then offer to buy the note at par + some amount. The buyer then goes back to the mortgagor, reduces the rate to or near market in return the mortgagor pays the buyer its costs to buy the note (maybe a little extra). The "default" is cured at that time and the FHA insurance reinstated

interested parties that HUD is acting correctly where it decides to approve any form of significant financial relief.

In our ongoing efforts to protect the FHA insurance fund and to assure investor confidence, we designed a program of required analysis and reporting that targets all default cases where there is a request for partial payment of claim, lockout override or other major financial relief².

Action Required:

Current policy requires that in every event of mortgage default, the Hub Director is required to assure a risk flag is placed into the Active Partner Performance System (APPS) for every known entity, principal and individual. Current policy also requires that the REMS Problem Statement Screen be updated to show the **most probable cause of the present default**.

In all cases where there is a request for partial payment of claim, lockout override or other major financial relief, the Hub Director will take steps to have the cause(s) of the default identified and verified by field personnel prior to recommending approval of the action to HUD HQ. Identification and verification by field personnel must be completed within 25 calendar days following the notice of default and will include:

1. A Project Manager's (PM) summary analysis:
 - a. Of the report on management operations performed in the three months prior to default. If such report is not available then the PM shall complete or cause to have completed (by a PBCA or CA) a management operations review as soon as possible³.

If the management review was completed prior to the default, the PM's summary analysis should discuss property and/or operational problems and events that are most likely to have led to the default. A post default management review should seek to uncover, **verify** and summarize property operational problems and events that caused the default. These causes are made part of the HUD record in REMS (part of the problem statement);

- b. Of the property operations as exhibited in the last three years annual financial reports and the PM's summary analysis of the last three physical inspection reports (as available). The PM summary shall

² While the program of review is required on all cases where a request for partial payment of claim, lockout override or other major financial relief, we encourage staff and management to use this approach for other defaults as well as a means to identify the cause of the default.

³ Resource limitations may delay completion of this action; lack of travel money etc. should be noted in the HUD record.

link specific problems, events and trends to the cause(s) and/or as contributing factors of the default;

- c. Of income and expenditures as shown in the monthly accounting reports from the owner. The PM summary shall link specific problems, events and trends to the cause(s) and/or as contributing factors of the default; and
 - d. Of significant tenant complaints received during the last three operating periods. The analysis should seek to link complaints to operational, financial or physical conditions identified in numbers 1, 2 or 3 above.
2. The PM's summary analysis will also examine the most recent and prior year's portfolio risk assessment, which shows the relative risk level assigned to the property. Where the property was not tagged as high risk, the PM shall summarize why and explain what happened that drastically altered the forecasted risk.
 3. The PM summary analysis will list all participant individuals and entities and show that were or were not flagged in APPS. For any participant who was not flagged, the PM's rationale will be documented in REMS and concurred on by the PC and Hub Directors.

Our intention is to assure that defaults are fully understood as part of HUD action and more precisely documented in HUD records. The PM report sent to the Hub Director should provide clear statements of the results of their analytical review. The work papers of the PM need not be included, but in some cases may be requested or reviewed as part of other HQ analysis

These analyses and the report should clearly explain for the Hub Director the cause(s) of the default and that the causes were unrelated to a simple desire by a participant to reduce interest rates, mortgage principal, etc⁴. Following review and acceptance of the PM's report, the Hub Director will take steps to assure that APPS and REMS are fully and completely updated as to cause of default and will send a copy of the PM's report to the Director, Office of Asset Management as evidence to support the financial relief requested by the owner. The participation review committee will also use the information developed when a participant with a

⁴ One should not confuse an interest rate reduction that purports to solve a particular event, action or symptom present in the property operations, with the cause of the default. For example, the default may be related to declining occupancy and income, but both of these are symptomatic of some larger cause; market decline, poor management, etc. Reducing interest rates and the recurring related expense can be part of a curative program designed to address a particular known problem or in the case of a non default refinancing a way to decrease expenses and increase returns. The absence of a cause for default should require additional review and investigation by the field office, HUD's Office of Inspector General, the Departmental Enforcement Center, etc.

record of default seeks new participation in HUD programs. Instances where a discrete cause(s) of a default cannot be reasonably identified and fully verified should be immediately referred to the Business Relations and Special Initiatives Division for further review and investigation and possible referral to the Departmental Enforcement Office. We will vigorously pursue all instances where there is an indication that the owner, mortgagee, or other party has manipulated HUD processes and procedures with intent to commit fraud.

If you have comments or questions about this policy please contact your desk officer.

flag on default4				
Originator	Concur	Concur	Concur	concur
Pollard	Hill	Hannon/Chandler	Bridges	