Draft Resource Desk Q&As
for HQLC Clarifications
Revised August 18, 2003

The following Resource Desk Q&As are provided in draft, for discussion on the August 25, 2003 conference call. Based on discussions during the call, OMHAR may revise the Q&As prior to posting them on the Resource Desk. Some issues discussed below (in particular, R4R-IDRR sizing, and residual value) are likely to result in updates to the OPG as well.

Introduction

The following Q&As will be added to the resource desk, in response to issues raised at various recent HQ Loan Committee sessions and identified by OMHAR staff as needing formal clarification. In this document, each set of Q&As is preceded by a numbered heading in bold, outlining the issue(s). Unless stated otherwise, these Q&As expand on existing guidance, and existing guidance continues to be effective.

1. Correctly Reporting Savings For Re-Entry Transactions

Q: How does OMHAR report savings, when a Lite (or AOTC) re-enters M2M and then closes as a debt restructure?

A: When the debt restructure closes, the savings formerly reported for the Lite (or AOTC) are removed. The savings for the debt restructure are calculated based on the original (pre M2M) above market rents. Using this approach, the correct savings are reported.

2. 2nd / 3rd Mortgage Interest Rates

Q2: When should PAEs consider an interest rate above 1% for second and third mortgages? [existing WEBPD296, updated May 2003]

A2: If, at a 1% interest rate, the second and third mortgages could be repaid utilizing less than 80% of the estimated residual value, the PAE should increase the interest rate, in 0.50% increments, and the PAE should propose the highest interest rate that will allow the second and third mortgages to be repaid using less than 80% of residual value. For example, if at a 2.0% interest rate, both 2nd and 3rd can be repaid using 63% of residual value, and at a 2.5% interest rate, both the 2nd and 3rd can be repaid using 89% of residual value, the PAE should propose a 2.0% interest rate. The interest rate may not exceed the Applicable Federal Rate published by the Internal Revenue Service (see http://www.irs.gov/taxpros/lists/0,,id=98042,00.html).

3. Provide a discussion of all situations in which the 1st mortgage may be underwritten with a DSCR below 1.20.

Q: When affordable (use restricted) rents are below market rents, the 1st mortgage must be underwritten using the lower affordable rents. However, when project-based assistance will continue after M2M, the Section 8 contract will use the higher market rents. Because the 1st mortgage underwriting is required to use the lower affordable rents, should PAEs use a DSCR below 1.20 in these situations?

A: Yes. PAEs may reduce the debt service coverage to as low as 110%, or even 105% if there is cushion elsewhere in the transaction. See also the May 15, 2002 memorandum. [Resource Desk will provide a See Also link to the memorandum]

Q: Other than situations with affordable rents below market rents, can an M2M takeout 1st mortgage be underwritten with a DSCR below 1.20?

A: Generally no. OMHAR requires a DSCR of at least 1.20 whenever HUD will hold the MRN / CRN.

4. Utility-Owned Transformers and PCBs

Q: If a property has utility-owned transformers not already marked ‘PCB Free’, what are PAEs supposed to do?

A: Send Form 4.8, requiring the owner to ask the utility company for its O&M plan. Do not make receipt of the O&M plan a condition of closing (the utility is under existing governmental requirements to manage its PCB risks, and we can rely on that for purposes of closing).

5. Reminder to Re-Determine Bond Redemption Costs When The Closing Date Changes

Q: How should PAEs calculate bond redemption costs?

A: PAEs should obtain an estimate from the issuer and review it for reasonableness. Important note: if the estimated closing date changes, be sure to re-contact the issuer to update the estimated redemption costs (the change in closing date may mean a much later or earlier bond redemption date than originally planned).

6. Reminder Regarding Changes in Tenant Utility Allowances

Q: What should PAEs do if a Restructuring Plan will result in an adjustment to the tenant utility allowance (for example, if air conditioning is being added and electricity is tenant-paid)?

A: PAEs should estimate the adjustment. In the Underwriting Model (RentInput page), the current utility allowance should be entered in the Current Rental Breakdown section, and the estimated new utility allowance should be entered in the Proposed Rental Breakdown section. In addition, PAEs should coordinate with the owner, management agent, and Multifamily field office to ensure that the utility allowance is actually adjusted after the M2M closing.

7. Issues Regarding Rent Loss (Vacancy and Bad Debt) Underwriting.

Q: One of our exception rent transactions has negative NOI at market rents and will use 223(a)(7) financing through OMHAR. Should the PAE underwrite the prevailing market rent loss (vacancy plus bad debt) or the property's historical rent loss, for 1st mortgage sizing purposes?

A: Because the property would not survive a discontinuation of project-based assistance, the PAE should underwrite the property's historical rent loss, but not lower than 5%, for 1st mortgage purposes. In similar situations, if financing other than 223(a)(7) is used, the PAE may underwrite a rent loss factor as low as 5% with the concurrence of the lender.

Q: The prevailing market rent loss (vacancy plus bad debt) is well above the 7% program minimum, and the property's historical rent loss is well below the 7% program minimum. Project-based assistance will continue after M2M. 223(a)(7) financing through OMHAR will be used. Underwriting the transaction at the prevailing market rent loss results in a major negative impact on the loss to HUD. There is no reason to expect the property's performance to decline. May the PAE underwrite the 1st mortgage rent loss at a rate below the prevailing market rate?

A: Yes. However, all of the conditions you specify are required, and the underwritten rent loss may not be lower than the 7% program minimum. PAEs and Production Offices should use their judgment in determining 'major negative impact', in determining that the property's future performance should be at least as good as the property's historical performance, and in determining that the transaction, as underwritten, will have adequate cushion and operating margin. Generally, the post-M2M HAP contract term should be 20 years, or there should be very sound reasons for believing that project-based assistance will be renewed. In similar situations, if financing other than 223(a)(7) is used, the PAE may underwrite a rent loss factor as low as 7% with the concurrence of the lender.

Q: Other than the situations discussed in the preceding two questions, are there any situations in which the PAE may underwrite a rent loss factor (vacancy plus bad debt) below the market rent loss, for 1st mortgage purposes?

A: Generally no. There may be some exceptions to this, such as where there is very strong evidence that market weakness will not continue, but this should be discussed with Headquarters before proceeding.

Q: When may PAEs underwrite 1st mortgage rent loss below the normal 5%+2% program minimums?

A: When both the market-wide and historical rent loss factors are below 2%, and project-based assistance will continue after M2M, the PAE may use a rent loss factor as low as 5% for 1st mortgage underwriting purposes. PAEs may use this approach for both market rent and exception rent restructures.

Q: If the 1st mortgage is underwritten higher than the 5% (vacancy) +2% (bad debt) program minimum rent loss, are PAEs required to use the same rent loss for 2nd mortgage underwriting purposes?

A: Generally yes. There may be some exceptions to this, where there is very strong evidence that property performance will improve, but this should be discussed with Headquarters before proceeding.

8. Relationship Between Cushion and Expense Underwriting

Q: Should PAEs underwrite taxes, utilities and insurance at expected amounts, or above?

A: PAEs should underwrite all operating expenses at the expected amounts. In particular, PAEs should not assume that the next insurance premium will be higher, unless there is good reason to believe so. The operating expense cushion provides an overall allowance, and it is not necessary or appropriate to provide additional cushion in individual line items.

9. 223(a)(7) Loan-to-Value Limitation

Q: When, if ever, is it permissible for a 223(a)(7) loan amount to exceed 100% of appraised value?

A: There is no statutory or regulatory LTV requirement in the 223(a)(7) program. OMHAR normally requires 223(a)(7) loans to be within the 100% LTV limit documented in the OPG. However, OMHAR Deputy Directors can approve OPG exceptions on a case-by-case basis.

10. Exception Rent Restructures and 221(d) and 223(f) Financing

Q: Can 221(d) and 223(f) loans be underwritten using M2M exception rents?

A: POs and PAEs should discuss this issue with the Multifamily Field Office that will be processing the loan. OMHAR understands that Field Offices have discretion to underwrite at M2M exception rents, by waiving certain administrative provisions. OMHAR also understands that these loans may require TAP processing instead of MAP.

11. Modeling of Tax and Insurance Escrows

Q: By showing the current balances in the tax and insurance escrows in the sources section of the model, the claim amount is reduced by that amount. We have an owner whose current escrows exceeded what was required to be escrowed by the new lender at closing. Let's say the excess was $10,000. The claim was reduced by that amount. The owner insists that the former lender had required excess reserves, and that those funds should be returned to the owner, not be used to reduce the claim. What do you say? [WEB10327050, 7/20/03]

A: The program regulations (24 CFR 401.472.a.1) require that all project accounts be utilized in the restructuring plan. The term "project accounts" encompasses surplus escrow funds, so it is proper to utilize the surplus escrow funds in the restructuring. However, if the new escrow requirements cannot be established accurately before closing, the PAE may allow existing balances to transfer to the new lender. Under no circumstances may any surplus be distributed to the owner at the M2M closing.

Q: How should PAEs reflect tax and insurance escrows in the Underwriting Model (Sources and Uses worksheet)?

A: The tax and hazard insurance escrows in the Sources should reflect the estimated escrow balances immediately prior to closing. The amounts in the Uses should reflect the escrow balances estimated to be required by the new lender at closing. If one or both escrows need to be increased, enter the escrow increase(s) in the Transaction Cost Detail (the owner is required to invest 20% of escrow increase amounts). To avoid double counting, the OHMAR Approved Transaction Cost figure in the Uses must be the total transaction costs minus the escrow increases. The current version of the underwriting model (version 4.31 and bifurcation model version 4.41) handles this automatically. For transactions with escrow increases that were modeled in prior versions, either upgrade to the current version or see the next two questions.

Q: How should PAEs reflect tax / insurance escrow increases, in versions of the Underwriting Model prior to version 4.31?

A: For all model revisions before 4.31 (or IRP Bifurcation 4.41): In the Uses section, the OMHAR-Approved Transaction Costs will typically be the total transaction costs. This cell should reference cell J42. Change this to be J42 minus J35 minus J36.

Q: If a pre-4.31 version of the Underwriting Model is upgraded to version 4.31, and the transaction involves tax / insurance escrow increases, how should the increases be modeled?

A: On the Sources and Uses page (Uses section), zero out the negative offset and delete the negative offset description. Then, check the OMHAR-Approved Transaction Costs, which should generally be the subtotal of transaction costs seen in cell J43. Change the cell to reference the amount in cell J43 if necessary.

12. Delinquent Mortgage Loans

Q: One of our full restructures has an FHA-insured mortgage loan that is routinely one month delinquent. The mortgagee has not elected to assign the mortgage, and mortgage insurance continues in force. Must the payments be brought current as a condition of the M2M closing?

A: OMHAR will defer to the judgment of the Multifamily field office. OMHAR is able to close the M2M transaction despite the delinquency, if the field office believes that is the best approach. However, PAEs and Relationship Managers should realize that there is a greater risk of accounting problems with the loan payoff, and of F47 problems, if the delinquency is not cured.

Q: One of our full restructures has a HUD-Held mortgage loan that is not current. Must the payments be brought current as a condition of the M2M closing?

A: OPG Section 3-2.C.1 requires that HUD-Held loans be current under the original terms, or current under a HUD-approved workout. If the Multifamily field office is willing to approve a workout (under which the loan would be current), that would remove the barrier to closing. Another alternative is to pursue a property-specific waiver by OMHAR of this OPG provision. OPG waivers require the signature of an OMHAR Deputy Director.

Q: One of our full restructures has a HUD-Held loan that is current under its workout agreement but has unpaid interest and unpaid Service Fees (from an earlier delinquency, prior to the workout agreement). How should these be treated in the M2M transaction?

A: The amount that should be reported as 'UPB For Loans To Be Restructured' (LoanInput page of the Underwriting Model) is the unpaid principal balance, plus delinquent interest, plus unpaid Service Fees, as of the M2M closing date.

13. Payables-Related Issues Not Discussed In The February 6, 2003 Broadcast

Q: Before the M2M closing, the Multifamily field office allowed the owner to withdraw funds from the Reserve for Replacements, to cover aged payables. Should PAEs require the owner to contribute 20% of these payables at the M2M closing?

A: No. However, OMHAR strongly recommends that PAEs coordinate closely with Multifamily field offices regarding management of the Reserve for Replacements account prior to the M2M closing, so that the actual Reserve balance at closing will be consistent with the amount the PAE included in the underwriting model.

Q: Before the M2M closing, the owner paid for Reserve-eligible items but could not be reimbursed because the Reserve balance was too low. Can the IDRR be increased to cover these items, so that the owner can be reimbursed after the M2M closing?

A: No. However, OMHAR points out that, if the payment caused the property to have a payables problem, the payables problem will be corrected as part of the M2M closing.

Q: One of our full restructures had significant negative Surplus Cash on its most recent audited financial statements, yet the owner is certifying that there are no excess payables. What should we do?

A: The PAE (or PO) can ask the owner to explain why there are no excess payables, despite the recent negative Surplus Cash. The owner's certification is not necessarily incorrect. It is possible, for example, that the deficiency was due to a Replacement Reserve withdrawal that did not arrive in time, or the property may have received a large property tax rebate in the current year. Similarly, inclusion of old loan interest and new loan interest as M2M transaction costs may have the effect of curing the Surplus Cash problem.

Q: May owners list, on the payables certification, accrued but unpaid owner distributions that could not be made in prior years because of inadequate Surplus Cash?

A: No.

14. Selecting An Appropriate IDRR and New Reserve Deposit

Q: What is the appropriate post-M2M minimum Reserve balance ("Floor")?

A: OMHAR normally requires a Floor equal to one year's deposits at the pre-M2M level. If the normal Floor is low (for example, materially lower than one year's post-M2M Deposits), the PAE should consider supplementing the IDRR in order to provide a more adequate minimum balance (in effect, adopting a higher Floor). If the normal Floor is high (for example, materially higher than two years' post-M2M Deposits), the PAE and PO should consider discussing the situation with the appropriate Multifamily Field Office, to see if the Field Office would accept a Floor that is more appropriate in light of the property's projected capital needs.

Q: If the PCA page of the model shows roughly level annual capital needs, how should PAEs set the new Reserve deposit and IDRR?

A: PAEs should model an IDRR equal to (or slightly greater than) the desired Floor, and Deposits equal to (or slightly greater than) average 20-year needs. In these situations, PAEs should not model large IDRRs, even when the required Deposit appears "large". All else equal, in these situations there is every reason to expect capital needs to continue at this level in years 21-30, and using a high IDRR / low Deposit strategy is likely to compromise the property's long-term viability.

Q: If the PCA page of the model shows annual capital needs that are significantly higher in the early years ("front-loaded needs"), how should PAEs set the new Reserve deposit and IDRR?

A: Many M2M transactions have higher needs in the first few years following the closing. If the high needs in the early years are not likely to re-occur in years 21-30, PAEs generally should size the Deposit equal to average needs for the remaining years, and an IDRR sufficient to maintain balances above the Floor. Otherwise, the PAE should consider setting the Deposit at the average annual need, and allowing a large ending R4R balance to build up that will help defray the expected high year 21-30 capital needs.

Q: If the PCA page of the model shows annual capital needs that are low in the early years and higher in the later years ("back-loaded needs"), how should PAEs set the new Reserve deposit and IDRR?

A: PAEs should not model significant IDRRs, because that likely would result in a Deposit that would be too low to meet the year 21-30 needs. Typically, the Deposit should be modeled at an amount that reflects average annual capital needs for the later years of the 20-year analysis.

Q: How should PAEs take the ending R4R balance (at year 20) into consideration, when setting the IDRR and new Reserve Deposit?

A: After modeling a trial combination of IDRR and Deposit, that produces ongoing balances at least equal to the Floor, PAEs should consider whether the ending balance (at year 20) is insufficient, adequate, or excessive. When making this determination, PAEs should take inflation into account. At a 2.5% inflation rate, $1 today is equivalent to $1.64 20 years from now; at a 3.5% inflation rate, $1 today is equivalent to $2 in year 20. Also, in making this determination, PAEs should consider whether the average annual capital needs for years 21-30 (in today's dollars) are likely to be the same as, less than, or more than the Deposit. If a number of high-cost systems will require replacement in years 21-30, a large ending balance is appropriate. Conversely, if very few high-cost systems will require replacement in years 21-30, a large ending balance would not be appropriate. In general, an ending balance that is less than one year's average annual capital needs (in year 20 dollars) is probably too low, and an ending balance that is greater than five years' annual average capital needs is probably too high.

Q: What capital needs trending rate should PAEs use (Input Assumptions page of the model)?

A: In general, this should be the same rate projected for the Long Term OCAF, Other Income Inflation Rate, and Expense Inflation Rate. OMHAR generally encourages PAEs to use a rate of at least 2.5%. Similarly, projected inflation rates higher than 4.0% are not supported by economists' current estimates.

Q: What reserve interest rate should PAEs use?

A: PAEs should model this rate using the investment returns (net of fees) that owners should expect to earn on surplus Reserve funds, if inflation matches the assumed capital needs trending rate. For example, if general inflation is 2.5%, short term interest rates likely will be 1% or less, and PAEs should model a zero interest rate if the mortgagee will charge investment fees, and up to 1% if no fees will be charged.

Q: When sizing the IDRR and new Reserve Deposit for Qualified Nonprofit Purchaser transactions, do PAEs need to take the 50 year Use Agreement into account?

A: No. The normal IDRR / R4R sizing will be sufficient.

Q: How should PAEs evaluate the year 21-30 capital needs?

A: PAEs should quickly review the building systems that produce the bulk of the 20 year capital needs (i.e., the lines that have the largest total cost over the 20 year analysis period), to judge whether the year 21-30 needs for those systems will be reasonably consistent with the year 1-20 needs. PAEs also should consider whether there are any long-lived systems that produce no needs in years 1-20 but that might produce needs in years 21-30 (for example, elevators, central boilers and chillers, siding, windows, tuckpointing of masonry walls, and underground utility pipes). If it appears that the year 21-30 needs will be materially higher (or lower) than the year 1-

20 needs, PAEs should consider raising (or lowering) the Reserve deposit, and adjusting the IDRR accordingly.

Q: When Section 236 IRP is being re-used for R4R deposits, how should PAEs approach the underwriting?

A: In general, if using IRP for R4R is the appropriate IRP-reuse strategy, it will make sense to use the shortest possible IRP re-use term. Typically, this approach will generate a large balance during the IRP re-use term (typically 9 to 14 years), and typically the balance will go down steadily, over the remainder of the 20-year analysis period. In these situations, it is especially important for PAEs to consider viability in years 21-30.

15. Issues Relating to Residual Value

Q: What standard of accuracy and reasonableness does OMHAR expect, for residual value estimates?

A: Estimating the residual value that a property may have at the end of term – usually 30 years – is clearly an exceptionally difficult process and true accuracy cannot be expected. However, OMHAR expects that the value chosen will be generally defensible based on common sense and acceptable underwriting reasoning.

Q: May PAEs estimate residual value using a modification of the underwriting model's residual value calculation?

A: Yes. For example, if there is information available for the area that indicates that the expenses in conventional transactions are notably lower, it would be possible to come up with a reasonable estimate by capping a net income derived using the model produced market rents but deducting expenses that are lower than the model produced expenses. The "year 31" expenses could be reduced by the same percentage that conventional expenses are lower than those in subsidized properties now. (Presumably one should assure that the expenses used to prepare the estimate are for similar types of properties in terms of construction, occupancy (family or elderly), and utility configurations.) Similarly, the PAE may determine that the Reserve deposit used in the model is materially higher than the Reserve deposit that appraisers would use in deriving value using the income approach.

Q: For market rate restructures, may PAEs use the residual value calculated by the model (capitalized NOI in the terminal year)?

A: Yes. However, PAEs should include a discussion of how the capitalization rate was selected.

Q: What factors should PAEs take into account when selecting a capitalization rate?

A: The cap rate may be the cap rate used by the appraiser, if the cap rates in the area have a history of stability, the property is expected to be well maintained, and the property is reasonably expected to retain a similar relative value going forward. Often, however, a higher cap rate will be used to reflect the overall wear and tear on the building, original lack of quality, possible impending economic obsolescence, or a market that is turning, or is likely to turn, slightly downward. The capitalization rate may also be affected by market issues of population, economic trends, and land value; as well as property-specific issues such as historic value and location.

Q: For market rent restructures, may PAEs use alternative approaches other than the residual value calculated by the model?

A: Yes, PAEs may use other residual value approaches that are adequately supported. Support for the estimate may be obtained from historical trends; observations from inspections; supplemental information from the original (or another) appraiser, realtor, or other knowledgeable source; or from fact-based formulae developed by the PAE and explained in the model or narrative. Justification for a higher or lower value than that calculated by the model should be based on known factors, identified in the model or narrative. Typical considerations would include historic value, exceptional location, declining markets, improving markets and land value.

Q: For exception rent restructures, how should PAEs determine residual value?

A: PAEs may not estimate residual value by capitalizing NOI from exception rents. The residual value calculated by the underwriting model is based on market rents for all years following expiration of the M2M Use Agreement (typically, year 31+). The PAE may use the year 31+ calculated value with no further explanation other than support for the capitalization rate selected. Alternatively, the PAE may use other residual value approaches that are adequately supported (support must include a discussion of why the year 31+ calculated value was not selected).