

Monday Underwriting Call – November 3, 2003

Vacancy Determinations Round 1

Remember to make a clear statement of what the vacancy is in the marketplace, or submarket. You will get this information from the comps, the appraiser's statements about the market, and from any other available resources such as apartment associations, information on the web, information from prior (but recent) deals, etc. Assure that any "indications" about the trends in that market – such as significantly falling population, increasing population, new construction, job loss, demolitions of substandard housing, etc. – are considered in your conclusion.

Once you have market, you should also make a clear statement on the vacancy history in the property – give past three years, address trends, indicate anything that might impact vacancy, such as the addition of air conditioning or new management, etc.

Once you have market (including comps) and historical vacancy in the property, you choose the vacancy for underwriting. GENERALLY, you will choose the market rate which reflects the operations without Section 8. Just as we are marking *rents to market* to reflect project operations in the event Section 8 is unavailable, we should be using the *market vacancy*.

In some cases, however, there would be a great loss to the property if we use the market vacancy factor (because the higher market vacancy factor means that less income is available for debt service on new debt and, thus, the partial payment of claim has to be higher). In some of these cases, you can use the property history instead.

First, you can use the property history when the transaction requires exception rents. The deal will fail without Section 8 anyway so the occupancy with Section 8 is the only thing that matters.

Second, you can use the factor developed from the property history when the loss is substantial, the Section 8 is expected to continue (say especially in an elderly property), and there is no reason to believe that the property performance will decline. This is addressed in the OPG and in recent Broadcast mailings.

Vacancy Determinations Round 2

If you have a transaction with a very low vacancy historically AND there is a sustained very low vacancy in the jurisdiction – we have said 2% in the Broadcast message - and there is no reason to believe that either will alter, you can use a vacancy factor as low as 5% combined for underwriting the first mortgage. This is true for both exception rent transaction and in non-exception rent transactions.

Why doesn't HQLC read the PAE's narrative?

(Because we like to approve more than one deal a week.)

It is correct that Headquarters Loan Committee does not review the narrative. Neither do they review the third party reports, the rest of the documents submitted by the PAE, or other than select parts of the model.

All of the above **are reviewed in full** by the OMHAR reviewer – either internal or FA. The reviewers use the material to complete their review of the transaction (the boxes in the review form) and to prepare their summary narrative that accompanies the transaction to committee.

The PAE's narrative is definitely not ignored. However, it, along with many other documents, cannot routinely be reviewed by the committee. This is why there are summaries and why staff who know the deal (and sometimes the PAE underwriter) are at the committee.

Acceptable Management Determinations

Based on discussion in a recent HQLC we wanted to discuss the evaluation of property management. This is covered in Chapter 4, section 8 and in Appendix K of the OPG.

While we frequently think of the evaluation of ownership and management together, we wanted to remind you all that in the statute and regulation, ownership and management are treated very differently. Rejections of Owners are subject to a standard of "material adverse financial or managerial actions or omissions" in regard to the property or similar HUD properties, while no such stringent standard exists for management agents.

The PAE does not have to show that management is in criminal violation, or that material adverse actions have been taken by management in order to have a reasonable basis to conclude that a change in property management is necessary. The PAE must use judgment and document issues when requesting changes.

Cases where a property is suffering financially and physically require the best judgment of the PAE, which must consider what role management plays in the distress. The PAE should consider such factors as:

- Is management generally producing sub-par results with above average expense levels?
- Are vacancies higher than similar properties? Are vacant units promptly prepped and rented within cash flow constraints? Are reserves used, if available, to make units ready?
- Are insurance claim losses promptly filed, and repairs promptly made with insurance funds?

- Do property insurance rates reflect extraordinary risks due to lax management?
- Are security concerns higher in the property than in the surrounding neighborhood? Do security costs reflect, in part, poor tenant selection and lease enforcement?

While we have always placed emphasis on the Multifamily view of the management, PAEs should voice their own evaluation to Multifamily as well. Multifamily may not be in close contact with the property and may need the leadership of the PAE in the evaluation.

OMHAR wants properties to emerge from restructuring with the financial, ownership and managerial strength to be well maintained for the full use agreement period. We need management that can utilize the resources – Reserves, Rehab Escrows, operating expense levels, that OMHAR and the PAE set up to make this a successful property. In our post-closing evaluations we are finding too many properties where funded Rehab Escrows are not being promptly used to upgrade property, where occupancy does not reach projected levels, where cash flow is not stabilized. Thorough evaluation of management, and requiring weak managers to be replaced, will help improve property performance.

Appeals

OMHAR HQ has gotten a number of appeals lately that involve issues that should have been resolved elsewhere:

- number of draws from the rehab escrow (something reasonable could be worked out with PAE)
- reasonable item requested too late (frustrating, but if appropriate, it's appropriate)
- appropriate items not given because it would require exception rents (as above)
- failure to allow (reasonable) contract amounts in the underwriting (get the contracts)
- failure to negotiate out resolutions (knowing you sometimes can't)

If the PAE is not getting what they need to do the deal, send a 10 day letter for non-cooperation and reduce the rents. Make clear that you will do that from the beginning.

There will be push back to the PAEs and the regions to resolve these issues where they belong. Going forward, issues that should have been raised and resolved with the PAE or Production Office in all likelihood will not be handled in the Admin Appeal process

Residual Value

Some PAEs have been providing several approaches to residual value and announcing they are not reasonable where the result is low. They then select the current value with no support other than the fact that it is higher. Please detail only the selected approach and provide support for it alone – e.g., “today’s value is higher than that determined in year 31 by the computer but we believe that this value will hold because of slow gentrification of the general area, the fact that the community is economically sound and

the population is increasing. These factors, plus the good condition anticipated because of reserves, support using no less than today's value. “

Trending Factors

In all cases, remember that the trend applied to income for the long term (called “likely long term OCAF” in the model”) can be no higher than the trend applied to expenses for the long term.

Closing/Post Closing Reorganization; Closing Processes – Getting on the calendar

Please refer to the 10/26 and 10/31 Broadcast messages on these subjects. These can be found at the following web addresses:

http://www.omhar.com/broadcasts/2003_1026.pdf
http://www.omhar.com/broadcasts/2003_1031b.pdf