U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

Special Attention of:

Regional Directors
Multifamily Hub Directors
Multifamily Program Center Directors
Multifamily Project Managers
All OAHP Portfolio Management Staff
All Owners of M2M Restructured Properties

Notice H 2011-30
Issued: October 19, 2011

Expires:
This notice remains in effect until amended, revoked, or superseded.

Cross References:
Handbook 4350.1 REV-1

SUBJECT: Use of Reserve for Replacement Accounts in Restructured Mark-to-Market (M2M) Properties

Summary:

The notice specifies special requirements governing the use of the Reserve for Replacements account that arise from the Mark-to-Market (M2M) program restructuring of a HUD Multifamily property's debt and rents. The notice also provides additional guidance on how the Reserve for Replacements account must be used for such properties that have completed a restructuring under M2M. In general, owners of M2M restructured properties are required to utilize the Reserve for Replacements account as the primary source for capitalized expenses, due to specific M2M requirements, as outlined in the notice.

Purpose

General guidance on the use of the Reserve for Replacements account in multifamily properties can be found in Chapter 4 of Handbook 4350.1 REV-1; however, there are special requirements governing the use of the Reserve for Replacements account that arise from the Mark-to-Market (M2M) program restructuring of a property's debt and rents. This Notice provides additional guidance on how the Reserve for Replacements account must be used for properties that have completed a restructuring under M2M. Guidance for multifamily FHA-insured properties not subject to M2M restructurings will be issued separately. In general, owners of M2M restructured properties are required to utilize the Reserve for Replacements account as the primary source for capitalized expenses. This is due to specific M2M requirements:

1) Multifamily Assisted Housing Reform and Affordability Act (MAHRA), requires HUD to fund the reserve accounts (both initially and annually) during restructuring so as to maintain the property in good order over the next 20 years.

2) The restructuring plan negotiated with the owner establishes monthly contributions to the reserve account and requires a percentage of surplus cash that remains thereafter, on an annual basis, to be available as payment on the M2M HUD-held surplus cash

notes called Mortgage Restructuring Notes (“MRNs”) and Contingent Repayment Notes ("CRNs").

The MRNs (and CRNs) represent the statutorily prescribed debt that HUD expects to be repayable from net project income, in exchange for paying out substantial partial payments of claims from the FHA insurance fund, to provide the cash necessary to complete the M2M restructuring process on behalf of that property owner.

Requirements Governing Use of Reserve for Replacements in M2M Properties

Restructuring Commitments. The Multifamily Assisted Housing Reform and Affordability Act of 1997, as amended (MAHRA), requires HUD to work with M2M-eligible and participating owners to develop a M2M Restructuring Plan. The Restructuring Plan requires an owner to rehabilitate its property, maintain adequate reserves and maintain the project in a decent, safe and sanitary condition, and repay to HUD the restructured debt.

MAHRA provides that, "[E]ach mortgage restructuring and rental assistance sufficiency plan shall require the owner or purchaser of the project to take such actions as may be necessary to rehabilitate, maintain adequate reserves, and maintain the project in a decent and safe condition, based on housing quality standards established by ... the Secretary...." (Emphasis supplied). See MAHRA section 514 (e)(5). HUD has, through its regulations, implemented this provision by requiring the owner to establish a Reserve for Replacements account and a plan for replenishing that account that will be sufficient to maintain the property in a decent and safe condition over at least the 20-year period that follows the restructuring. Adequate reserves for specific and negotiated capital replacements and repairs are an integral part of the restructuring process and nothing contained in either MAHRA or its implementing regulations contemplates the use of project operating income to fund any major replacements or repairs.

Clearly, the Reserve for Replacements account must be the first source to fund these capital replacements or repairs in M2M-restructured projects. Under the MAHRA implementing regulations, an owner and HUD must evaluate the physical condition of a property undergoing a rent and debt restructuring (the "Restructuring") and then determine (i) the capital repair or replacement items that will be necessary to maintain the long-term physical integrity of the property, and (ii) an estimate of the initial deposit to the Reserve for Replacements, together with the estimated monthly deposits thereto, needed to maintain the physical integrity of the property for the next 20 years. (See 24 CFR 401.450, 451 and 453.) This analysis includes a review of all building systems and components. After these determinations are completed, the owner receives from HUD a term sheet that includes, among other funds to be generated and used through the Restructuring, the amount of funding which may be added to establish the Reserve for Replacements account. The funding that becomes the opening amount of the Reserve for Replacements account is called the "Initial Deposit to the Reserve for Replacements account" (or "IDRR"). Once approved by the owner, the IDRR becomes one of the terms and conditions of the M2M Restructuring Commitment (the "RC"), which is the contractual agreement between HUD and an owner that contains the terms and conditions for a Restructuring and, by its own terms, survives closing as a binding contract document.

Establishing the initial Reserve for Replacements account and the amount of monthly contributions to the Reserve for Replacements account from project operating income in amounts sufficient to maintain the long-term physical integrity of the property is a critical component of the Restructuring; the IDRR and R4R contributions underwritten into the M2M Restructuring are sized specifically to be adequate for the needs identified in the 20-year schedule, which include all building systems and components. At the time of the Restructuring, the primary source of funding for the Reserve for Replacements account is the payment of a claim from HUD's FHA General Insurance Fund, and the amount of the IDRR increases HUD's claim against the FHA Insurance Fund on behalf of the property owner.

The size of the claim to the FHA Insurance Fund contributes directly to the amount ultimately determined to be the original principal balance of the Mortgage Restructuring Mortgage. However, the original principal amount of the Mortgage Restructuring Mortgage is limited by MAHRA and a corresponding regulation to "the amount that the Participating Administrative Entity (PAE) reasonably expects to be repaid based on objective criteria <u>such as the amount of anticipated net cash flow,</u> trending assumptions, amortizations provisions, and expected residual value of the property." (Emphasis added; see 517(a)(1)(B)(ii) and 24 CFR 401.461(a)(2)(i)). Pursuant to MAHRA and the corresponding regulation, the owner and HUD must determine the anticipated reasonable and necessary operating expenses for a property (including monthly contributions to the Reserve for Replacements account), in order to enable the PAE to project the amount of "net cash flow" that will be available to service the Mortgage Restructuring Mortgage during its term. (See MAHRA section 517(a)(3)) and the corresponding regulation 24 CFR 401.461(b)(3)(i)). Once this projected cash flow amount is calculated, HUD is then able to determine the amount of (or "size") the Mortgage Restructuring Mortgage, which is by statute, constrained to an amount that "can reasonably be expected to be repaid."

The statutory requirement to size the M2M debt to be reasonably repayable, with that repayability modeled upon the anticipated and agreed-upon cash flow assumptions of the property, reflect the statutory intent that the property operations after restructuring follow the terms of the Restructuring Commitment. Specifically, the statute intends that operating income is utilized for the underwritten property operating expenses, including deposits to the Reserve for Replacements account, resulting in the cash flow that will then be available to repay the M2M debt. The determination that the M2M debt can reasonably be expected to be repaid is important to its consideration as being "real debt". It is notable that the Internal Revenue Service, in IRS Revenue Ruling 98-34 exempts the MRM "Second Mortgage" from section 7872 of the IRS Code, which might otherwise view below-market and/or non-repayable debt as taxable debt relief.

In summary, the rents, operating expenses, 20-year schedule of needs, the IDRR, monthly deposits to Reserve for Replacements account, and the projected surplus cash from the property are matters negotiated and agreed to by HUD and the owner. This agreement is memorialized in the RC, which by its terms, continues to bind HUD and the owner after the closing of the Restructuring. Moreover, the documents that evidence, secure or otherwise are executed as part of the Restructuring confirm that the Reserve for Replacements is "to cover the cost of major replacements that are for the purpose of effecting replacement of structural elements and mechanical equipment of the Project or for any other purpose approved by HUD". (This language can be found in Section 1 of the Rider for the M2M first mortgage loan or Section 3 of the Rider for the Mortgage Restructuring Mortgages.)

Restricted Use of Operating Income. As described above, the Mortgage Restructuring Mortgage must be sized at an amount that can "reasonably be expected to be repaid" from post-restructuring operation of the property. As such, operating income is restricted for use on normal operating expenses, including deposits to the Reserve for Replacements account, and excluding the capital repairs and replacements specifically defined in the 20-year schedule and funded through that Reserve for Replacements account. The Reserve for Replacements account must therefore be the primary source of funding for capital repairs and replacement items.

Each Mortgage Restructuring Note (MRN) under MAHRA includes a definition of "Surplus Cash" that also provides additional guidance that the use of operating income is restricted. Subsection 2.e. of each MRN defines Surplus Cash as "any cash remaining at the end of a Payment Period after:

(1) The payment of (i) All sums due or currently required to be paid under the terms of (a) the [first mortgage] Loan if any, the lien for which is prior to the lien of the Mortgage Restructuring Mortgage securing this Mortgage Restructuring Note, and, (b) if applicable, subordinate FHA insured or HUD held mortgages with cash flow priority ("Priority Cash Flow Indebtedness") to this Mortgage Restructuring Note; (ii) all amounts required to be deposited in the reserve fund for replacements; (iii) all other obligations of the Mortgaged Property other than the Loan and Priority Cash Flow Indebtedness, unless funds for payments are set aside or deferment of payment has been approved by the Secretary, and (iv) the Capital Recovery Payments, if any; and...."

In summary, monthly deposits to the Reserve for Replacements account are included as an item subtracted from operating income to determine Surplus Cash. Since funds have been set aside to pay for the cost of major replacements of structural elements and mechanical equipment, they cannot be considered as part of "all other obligations..." under subsection (iii) above. Finally, Surplus Cash is not derived until after additional contributions to the Reserve for Replacements account have been made, the deposits are intended to cover the cost of these items without resorting to the use of operating income to cover the costs.

Insufficient Reserve for Replacements Funding

If HUD or the owner is concerned about the amount remaining in the Reserve for Replacements account, HUD will consider an owner's written request to:

(1) use operating income to pay for a specific capital improvement or replacement component, or

(2) increase the monthly deposit amount if there is an unexpected event that requires an expenditure from the Reserve for Replacement account. However such a request is an exception to the general rule that the R4R account must be the primary funding source for capital improvements and replacement items for all M2M-restructured properties.

Requests to use operating funds or increase the monthly reserve deposit must be submitted to the local Multifamily Project Manager assigned to the project. Any request to use operating funds must include the basis for the request and supporting documentation. Such request must be approved in advance, in writing, by the Program Center Director, in the same fiscal year so as not to affect surplus cash.

Summary

The underwriting of a M2M property includes:

a comprehensive 20-year physical needs assessment, which includes all building systems and components,

establishment of a reasonably repayable MRM based on an approved net cash flow, a detailed analysis of the needed Initial Deposit to the Reserve for Replacements account, inflationary adjustments to the 20-year needs schedule; and

calculated Annual Deposits to the Reserve for Replacements account that ensure a sufficient ending balance in year 20 to cover major systems that may be at the end of their useful life.

The M2M underwriting process also takes into account historical project expenses and input from project owners to determine the 20-year repair, maintenance and replacement needs. The results of this collaborative effort among all parties, including the owner, are incorporated into term sheets that ultimately become important terms and conditions of the Restructuring Commitment. An owner's discretionary use of operating income instead of Reserve for Replacements to fund capital repair and improvement items is contrary to the letter and intent of this underwriting and restructuring process, and undermines the integrity of the M2M program. Accordingly, and as noted above, the Reserve for Replacements account must be the primary funding source for capital improvements and replacement items for all M2M-restructured properties.

This Notice is effective immediately. Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-877-TDD-2HUD (1-877-833-2483). Questions regarding this Notice may be directed to Michael R. Murphy at 202/402-8388 or michael.r.murphy@hud.gov.

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