



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

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

October 10, 2012

**MORTGAGEE LETTER 2012-20**

TO: All FHA-Approved Multifamily Mortgagees

SUBJECT: Underwriting Instructions for Projects Converting Assistance as part of the Rental Assistance Demonstration (RAD) Program

**I. PURPOSE**

This Mortgagee Letter (ML) provides underwriting guidelines for Multifamily Accelerated Processing (MAP) lenders applying for FHA multifamily mortgage insurance on transactions involving properties converting rental assistance under the Department's Rental Assistance Demonstration Program (RAD). RAD was launched under Public and Indian Housing (PIH) Notice 2012-32 on July 26, 2012. This ML addresses underwriting criteria, eligibility requirements, application exhibits and the process for HUD application review when an FHA insured mortgage is proposed for a project converting assistance under RAD.

**II. BACKGROUND**

RAD provides the opportunity to test the conversion of public housing and other HUD-assisted (Rent Supplement, Rental Assistance Payment and Section 8 Moderate Rehab) properties to long-term, Project-Based Section 8 rental assistance to achieve certain goals, including the preservation and improvement of these properties through access by Public Housing Agencies (PHAs) and owners to private debt and equity to address immediate and long-term capital needs. RAD is also designed to test the extent to which residents have increased housing choices after the conversion, and the overall impact on the subject properties.

Many public housing properties have significant capital needs, and due to program restrictions, have not had flexibility to obtain public and private debt and equity to make needed repairs and renovations. Additionally, Rent Supplement (Rent Supp), Rental Assistance Payment (RAP), and Section 8 Moderate Rehabilitation (Mod Rehab) properties have not had the ability to obtain long-term Section 8 rental assistance contracts. These properties have expiring contracts that put at risk the rental assistance for residents, as well as the viability of the projects as affordable housing. Properties that participate in RAD may convert public housing or Mod Rehab assistance to Section 8 Project-Based Rental Assistance (PBRA) contracts, or may convert public housing, Rent Supp/RAP, or Mod Rehab assistance to Section 8 Project Based Voucher (PBV) assistance. PHAs and private owners of Rent Supp, RAP or Mod Rehab properties may then leverage the PBRA or PBV assistance contract to attract new financing.

RAD has two separate components:

- First component: projects funded under the public housing and Mod Rehab programs may convert their assistance to long-term, project-based Section 8 rental assistance contracts. Under this component of RAD, PHAs and Mod Rehab owners may choose between two forms of Section 8 Housing Assistance Payment (HAP) contracts: PBVs or PBRA. PHAs and Mod Rehab owners will convert their assistance at current subsidy levels. The 2012 Appropriations Act authorizes up to 60,000 units to convert assistance under this component, to be selected competitively. This component of RAD is authorized through Fiscal Year (FY) 2015, unless the cap is reached sooner, with the first applications accepted between September 24, 2012 and October 24, 2012, and initial selections anticipated shortly thereafter.
- Second component: owners of projects funded under the Rent Supp, RAP and Mod Rehab programs may convert the funding for tenant protection vouchers (TPVs) that would otherwise be provided as tenant-based assistance (or has been provided as tenant based assistance, in certain cases) to PBVs, upon contract expiration, or, for owners of Rent Supp and RAP projects, termination of the contract, occurring after October 1, 2006 and no later than September 30, 2013. While there is no cap on the number of units that can convert assistance under this component of RAD, and no requirement for competitive selection, actions under this component are subject to the availability of TPVs. For projects with contracts expiring on or before September 30, 2013, this component of RAD is already underway, with RAD requests made on a rolling basis. In the 4<sup>th</sup> quarter of Fiscal Year 2013, HUD will consider conversions of contracts expiring in 2014 or later, subject to the availability of tenant protection voucher funding.

FHA multifamily mortgage insurance is an important source of debt financing for projects participating in RAD. Underwriting of public housing, Mod Rehab, Rent Supp and RAP properties with PBV or PBRA assistance under RAD will mirror the underwriting of other properties assisted with Section 8 PBV or PBRA assistance. HUD endorses many transactions each year involving the acquisition, refinance and rehabilitation of PBRA or PBV-assisted projects. However, HUD is making certain allowances for processing RAD transactions that utilize FHA insured debt to accommodate and expedite these transactions, as described below.

### **III. PROJECT ELIGIBILITY**

Transactions that meet the following requirements may be processed under this ML:

- A. Public housing and Mod Rehab projects applying under the first (competitive) component of RAD that have received a HUD Commitment to Enter into a HAP Contract (CHAP). PHAs and Owners that apply to convert public housing or Mod Rehab assistance under the first component of RAD will be notified of selection via issuance of an award letter, signed by HUD. Attached to the award letter will be the CHAP, which shall indicate the HUD-approved terms and conditions for conversion of assistance. The CHAP will not be subject to negotiation by the PHA or any third party. The CHAP will serve as confirmation to FHA lenders that the project has been selected for RAD conversion and describes the terms under which HUD will enter into a HAP contract with the owner. HUD will not accept an FHA insured loan application on a public

housing project converting assistance under RAD, or a Mod Rehab project applying under the competitive component of RAD, unless a CHAP has been issued.

- B. Mod Rehab projects applying to convert assistance under the second (noncompetitive) component of RAD. The FHA application may be submitted prior to, simultaneously with, or after, the Owner submits the RAD request to HUD. This may include retroactive or prospective conversions. Mod Rehab projects must comply with the requirements of Section 2 of PIH Notice 2012-32.
- C. Rent Supp and RAP projects pursuing retroactive conversions of assistance (see Section 3.7 of PIH Notice 2012-32), and Rent Supp and RAP projects with original contract expiration dates on or before September 30, 2013 that have submitted or will submit requests for prospective conversions of assistance under RAD (see Section 3.6 of PIH Notice 2012-32). This includes properties that wish to prepay and refinance during FY 2013 (at the time of the mortgage prepayment, the contract will terminate and the RAD conversion will be completed).
- D. Rent Supp and RAP projects with original contract expiration dates after September 30, 2013, where Owners have submitted a letter of intent to HUD on or before April 1, 2013 requesting the opportunity to participate in RAD, and HUD has provided the Owner with a letter of invitation to submit a RAD request (see Section 3.6.3 of PIH Notice 2012-32). If the RAD application involves a prepayment of a mortgage on a Rent Supp or RAP project and the Rent Supp or RAP contract has an original expiration date after September 30, 2013, the transaction will only qualify for processing under this ML if the project has received a letter of invitation from the RAD program on or after April 1, 2013.

#### **IV. GENERAL UNDERWRITING GUIDANCE**

- A. Expedited processing: The Department will expedite application processing for all FHA-insured RAD transactions, as described in Section V, below.
- B. Eligible borrowers: Each RAD project underwritten with FHA mortgage insurance must be owned by a single-asset entity that may be formed by a PHA (in the case of public housing) or a private or nonprofit owner (in the case of a Rent Supp, RAP or Mod Rehab property). This ML uses the term PHA/owner to describe the entity applying for a RAD conversion, and to describe the RAD conversion materials that must be submitted to HUD directly from the PHA/owner entity requesting the RAD conversion. The term Borrower refers to the single-asset entity formed by the PHA/owner that will be the mortgagor in the FHA insured loan application made to HUD by the MAP lender.
- C. Loan-to-Value/Loan-to-Cost and Debt Service Coverage: Standard FHA underwriting terms and conditions, including LTV/LTC and DSC for Section 221(d)(4) and Section 223(f), will apply to all RAD transactions. RAD projects will qualify as “affordable” transactions and may be underwritten to these terms and conditions. If 90 percent of the project units will receive PBRA or PBV assistance as a result of the RAD

transaction, the project will qualify for the underwriting terms specific to rental assistance properties. (Please refer to ML 2010-21 for details on underwriting terms specific to affordable and assisted properties.)

- D. Davis-Bacon wages: Davis-Bacon wage requirements must be met for all Section 221(d)(4) substantial rehabilitation transactions. To be eligible for the Section 221(d)(4) program, the transaction must meet the threshold requirements in Section 3.4 of the MAP Guide. Davis-Bacon wage requirements are not required for Section 223(f) transactions. However, Davis-Bacon wage requirements are a requirement for initial repairs for public housing projects converting under RAD. Please see PIH Notice 2012-32, Sections 1.6.D.3 and 1.7.C.2.
- E. Use Agreement: RAD projects will carry a RAD Use Agreement which will be recorded superior to other liens on the property (including FHA closing documents), run for the same term as the initial HAP contract, automatically renew upon extension or renewal of the HAP contract for a term that is co-terminus with the renewal term of the HAP contract, specify the ownership and control provisions of RAD projects, and remain in effect even in the case of abatement or termination of the HAP contract. The lender and HUD underwriting staff must ensure that the RAD-specific Use Agreement is included in the closing package and recorded in first position at closing of the loan.
- F. Mortgagee approval is required prior to transfer of assistance to another property: Consistent with standing Section 8 HAP Contract policy, and pursuant to the RAD statute, HUD may approve the transfer of part or all of a rental assistance contract and a RAD Use Agreement to unassisted units owned or controlled by a public or non-profit entity. No transfers will be authorized without prior lender and/or investor approval. HUD may only approve a transfer if the project is economically non-viable, physically obsolete, severely distressed, or uninhabitable due to unforeseen circumstances such as natural disasters, or the transfer is in the best interest of the project's residents. The transfer of assistance may occur at conversion or after 10 years from the effective date of the initial contract (unless a transfer is needed sooner as a result of a natural disaster).
- G. Project Capital Needs Assessment (PCNA) Requirements: For public housing and Mod Rehab transactions, the RAD program requires submission of a RAD-specific standard Physical Condition Assessment (PCA) report that meets the requirements detailed in Section 1 of PIH Notice 2012-32. This PCA report meets all the criteria of the MAP Guide PCNA report and is to be submitted in lieu of the MAP Guide PCNA, with an update if required in order to be current at the time of the application for FHA mortgage insurance.

As described in PIH Notice 2012-32, the PCA will provide detailed analyses all standard building components, as well as energy saving alternatives and other green building components, including payback and cost/saving analyses. The PCA must be completed by a qualified, independent third-party inspector as required in the Statement of Work and submitted to HUD upon completion and within 90 days of acceptance of the project into the RAD program. For the purposes of FHA underwriting, the cost of developing this

RAD PCA report is mortgageable.

1. Under the first component of RAD, PHAs and Mod Rehab Owners are eligible for competitive rating points if the PHA or Owner commits to pursue and achieve an industry-recognized standard and certification for green building, as described in PIH Notice 2012-32. The RAD PCA will identify and recommend a scope of work that must be undertaken at the project to reasonably achieve the identified green building standard. In such projects, the lender must ensure that the FHA underwriting includes all the costs of the repairs the PHA proposed for receipt of scoring points in the RAD competition. HUD will carefully review and monitor the project to ensure this work is completed.
  2. Rent Supplement and RAP projects, which fall under the second (noncompetitive) component of RAD, are not required to complete a RAD PCA. A standard, MAP-compliant PCNA report is required for these transactions.
- H. Environmental Review: Lenders, Borrowers and HUD staff must follow the requirements detailed in Chapter 9 of the MAP Guide.
- I. Appraisal Guidance: In general, the appraisal and underwriting guidelines for Section 223(f) and Section 221(d)(4) programs will be utilized for RAD projects. However, under the Section 223(f) program, the appraisal will be based on how the project is expected to operate as assisted housing. Typically, under MAP Section 223(f), the appraisal is to value the property based on an unrestricted market basis, including rents based on the operation of the project without rent restrictions. If applicable, the project is also analyzed for debt service purposes with subsidies or similar restrictions and/or benefits. Under RAD, the valuation and rental assumptions are to be based on the Section 8 rental income and on the project Use Agreement. Consequently, the Net Operating Income (NOI) may be the same for both the Valuation used in Criteria 3 and the Debt Service analysis in Criteria 5. For purposes of valuation, the rents established by the RAD conversion will control, and the appraisal for the project should assume a jurisdictional exception in accordance with the current Uniform Standards of Professional Appraisal Practice (USPAP) to comply with the RAD statutory language in the Consolidated and Further Continuing Appropriations Act of 2012 (Public Law 112-55) and PIH Notice 2012-32. The appraiser must cite which portions of the USPAP are being excepted in the appraisal assignment.
1. Estimating the (NOI): The estimate of income and expense shall consider the underwriting guidance in paragraphs 5 and 6, below. The occupancy rate shall be the lesser of: 1) that indicated by market and historic performance, (reconcile historic occupancy higher or lower than market); or 2) the maximum allowed by the loan program used. If in the first criterion, the project has a higher vacancy than market recently due to taking units off line in anticipation of the proposed program of rehabilitation, rely on market occupancy levels.
  2. Approaches to Value:

- a. Capitalization: Capitalization rate development must include a thorough discussion of rates derived from the most relevant transactions and investor surveys. The Band of Investment method may also be employed using an equity dividend rate based on the best information available. The Section 8 contract and any favorable financing specific to the application may be factored into the rate analysis. The Lender's underwriter must adjust the capitalization rate for underwriting purposes, if necessary to ensure that the underwritten capitalization rate is greater than the mortgage constant. (The capitalization rate concluded by the appraiser will typically be greater than the mortgage constant.)
  - b. Sales Comparison Approach: A Sales Comparison Approach using a minimum of three comparables is required. It is recognized that assisted comparables may not be available. However, the appraiser will use the best available comparables and make adjustments as needed. Without a Sales Comparison Approach, it will not be possible to know how the subject compares to other recent sales within the market area.
  - c. Cost Approach: On a Section 223(f) transaction, the Cost Approach is optional at the discretion of the appraiser for structures that are 10 or more years old.
  - d. 221(d)(4) Substantial Rehabilitation: The "as is" value estimated by the appraiser should reflect a true market transaction, using the existing occupancy, income and operating expenses. The value used at line 73b, Section G, Estimated Replacement Cost, on the HUD-92264, shall be the lesser of this amount or that estimated by the Residual Method described at Section H, Remarks, of the HUD-92264.
3. Contract terms: Projects that participate in RAD, depending on which component, will convert assistance to either a Section 8 PBV or a PBRA HAP Contract. These contracts will have terms of 15 to 20 years, as detailed in Notice PIH 2012-32, subject to annual appropriations. For PBV conversions, the initial contract will be for a period of at least 15 years (under the first component of RAD, this term may be up to 20 years, upon approval of the administering voucher agency). For PBRA conversions, the term of the contract is 20 years. All contracts are subject to annual appropriations. For public housing conversions, at the end of the initial 15 to 20 year contract term, HUD shall offer, and the Owner shall accept, renewal of the contract for an additional term, subject to the terms and conditions applicable at the time of renewal and the availability of appropriations each year for such renewal.

4. Choice-Mobility: The underwriting should assume the project-based assistance for PBRA and PBV contracts will remain in place even if residents move from the property to utilize tenant-based assistance. (PHAs and Mod Rehab Owners converting assistance to PBRA are required to provide a Choice-Mobility option to residents of covered projects, unless they received a “good-cause” exemption. This choice-mobility feature for PBRA functions similarly to the PBV program.)
5. Project Rents: Section 8 PBV and PBRA rents will be set by formula as part of the RAD conversion request.
  - a. For the first component of RAD, PBV and PBRA rents will be listed in the CHAP that will be issued to the PHA/Owner upon selection for RAD, and will be adjusted annually by an operating cost adjustment factor at each anniversary of the HAP contract. Please see Section 1.6 and Section 1.7 of Notice PIH 2012-32 for more information.
  - b. For the second component of RAD, PBV rents will be set at the lesser of the PHA “reasonable” rent for the unit or 110% of FMR (or any exception payment standard approved by HUD).
  - c. For Section 8 HAP contract units, the rents used in the FHA insured loan underwriting must be at or below the rents listed in the project CHAP (for first component projects), or must be at or below the PBV rents authorized by the PHA with jurisdiction over the project. These rents are based on FMRs as a proxy for market rents.
  - d. If rents proposed in the FHA underwriting for the Section 8 PBV or PBRA units are above the rents allowed under RAD, the application will be rejected. If the project is partially-assisted, for example a partially assisted Rent Supp or RAP project, the unassisted units must be limited based on market comparables identified in the project appraisal. However, in a Rent Supp or RAP project, underwriters should take care to address the distinct rent-setting mechanisms that may restrict rents to Section 236 program requirements. If a public housing project will convert only a share of the units to the PBRA or PBV contract, the underwriting must specify whether those non-converting units will operate as market-rate housing or with some other rent restriction (i.e. Low Income Housing Tax Credits).
  - e. In public housing projects, because rents listed in the CHAP are derived from the current subsidy levels in the project, it is possible that the CHAP rents may be above market comparables. The appraisal therefore must include a rent comparability study. If the appraisal determines that the CHAP rents are above market, the

lender may underwrite the loan using the market rents, or may choose to underwrite using an “A” piece and a “B” piece with the “B” piece covering the above-market tranche, amortizing over the term of the rental assistance contract.

6. Project expenses. Lenders must take care when underwriting expenses for RAD transactions, in particular for public housing, which is converting from a distinct management and funding model. As a result, expenses in proposed underwriting may be lower than historical operating expenses, particularly if the Borrower is proposing changes in management or oversight as part of the conversion. The underwritten expenses must be shown to be achievable based on comparison of historical, and Borrower budgeted projections, considering the potential efficiencies from proposed repairs and considering similar subsidized properties.
  - a. Resident association funding and resident services funding. All public housing RAD conversions will require the Borrower to provide \$25 per occupied unit per annum in resident association funding. These costs must be included in the FHA underwriting as part of operating expenses.
  - b. Underwriting of non-shelter services. An Owner/PHA may propose non-shelter services in RAD projects. For underwriting purposes, the Owner/PHA may propose an external funding source for the services, or may use surplus cash. Form HUD-92013-E or a similar presentation must be submitted with the MAP application when non-shelter services are proposed. No more than 15% of the project’s effective gross income may be used for supportive services. The underwriter will need to evaluate and determine the expenses are generally reasonable, sustainable, and commensurate with the level and type of services. FHA cannot provide multifamily mortgage insurance for projects proposing services such that the project would be commercial in nature or they undermine the predominantly residential character of the property.
  - c. Supportive services in PBV projects. If the PHA/owner is proposing to convert more than 50% of the units in the property to PBV assistance using the supportive services exemption described in PIH Notice 2012-32, the PHA/owner will be required to carry forward non-shelter services in place prior to the RAD conversion (or to ensure that residents will begin to receive these non-shelter services at the time of execution of the HAP contract). In such projects, the lender must carefully review the proposed services, and if they will be funded from an external source, should look for a memorandum of understanding or other written agreement that demonstrates the services will be in place at the time of closing. The PHA is solely responsible for defining services and monitoring services in PBV



projects. The lender should ensure that the PHA/owner has capacity to ensure there will be services provided to project residents to comply with the PBV service requirement. HUD's Office of Public and Indian Housing (PIH) will monitor the PHA to ensure the supportive services are in place to meet the PBV requirement.

- J. Real estate tax abatements. FHA will only recognize real estate tax abatements that run with the land. In addition to this established FHA policy, FHA underwriting will consider property taxes as follows:
1. For Mod Rehab, Rent Supp and RAP projects, property taxes will be underwritten not less than the most recent tax bill amount. For public housing conversions, where the Borrower indicates continuation of a Payment In Lieu of Taxes (PILOT), the Borrower must provide legal opinion based upon state and local law of continuation of PILOT post conversion.
  2. Where the Borrower does not indicate continuation of a PILOT, the Borrower must provide documentation of real estate tax estimates.
- K. Reserves. RAD Borrowers will be required to make Initial Deposits and/or Annual Deposits to Replacement Reserves in accordance with standard Section 223(f) and 221(d)(4) substantial rehab requirements for affordable properties. For public housing and Mod Rehab properties applying under the first component of RAD, the lender will refer to the required RAD PCA to determine the ADRR and IDRR.
- L. Loan sizing (HUD -92264A). In sizing the loan mortgage amount, MAP underwriters are to comply with the MAP Guide instructions with the following exceptions:
1. Criterion 3: Loan-to-Cost/Loan-to-Value: The subject project estimated value is to be based on rent restrictions and use agreements. Rents should be based on the RAD rents established by CHAP, or if there are unsubsidized units in the project, should account for any rent restrictions.
  2. Criterion 5: Debt Service Coverage (DSC): Debt-service coverage maximum loan criterion is to be sum of the following tranches:
    - a. Project's NOI based on estimated project performance, at market rents multiplied by FHA program's DSC ratio, divided by the loan constant.
    - b. Plus, annual RAD rental income exceeding market rents, multiplied by FHA program's DSC ratio, divided by the mortgage constant based on an amortization period consistent with the term of the subsidy contract.
    - c. Plus, if applicable, tax abatement or IRP multiplied by 1.0 divided by the mortgage constant.

M. Development team capacity. The lender must perform appropriate due diligence on the mortgagor capacity and creditworthiness.

1. In accordance with PIH Notice 2012-32, for public housing and Mod Rehab conversions under the first component of RAD, within 30 days of acceptance into the RAD program, the PHA/Owner must identify its proposed development team members, with evidence demonstrating, as applicable, the team's recent successful experience financing, developing, rehabilitating, constructing, owning, and operating similar properties. The statement must describe teaming partner relationships, including resumes. If multiple sources of financing have been identified for the project, the development team must have experience with at least three transactions with mixed or multiple sources of financing. As in any FHA insured transaction, the lender will make an assessment of the capacity of the proposed Development team, and HUD staff will review this determination. If, in the lender or HUD's determination, the applicant does not demonstrate it has sufficient relevant experience, the lender or HUD may require an applicant to bolster its development team as a condition of an FHA Firm Commitment.
2. At this same milestone, the PHA/Owner must submit to HUD a Lender Engagement or Commitment Letter. In order to provide this Letter, the MAP lender must evaluate the capacity of the Borrower's development team to successfully complete the RAD application, based on the information described above. HUD will screen for "Troubled PHAs" as part of the RAD application process. The firm commitment application to the Department must include an analysis describing the PHA/Owner development team's recent successful experience with similar rehabilitation or construction projects, and the successful management of Multifamily Assisted Housing (either Project-Based Section 8, or Public Housing). If multiple sources have been identified for the project, the development team must have experience with at least three transactions with mixed or multiple sources of financing. In addition, no member of the development team and proposed ownership may be debarred, suspended, or subject to a Limited Denial of Participation.
3. In addition to this review, lenders should look to Chapter 8 of the MAP guide, and its treatment of Nonprofit mortgagor capacity, as a benchmark for underwriting of Borrowers under RAD. A Section 2530 previous participation review must be completed.

N. Developer fee. A developer fee is authorized on all RAD conversions, including conversions of public housing, Mod Rehab, Rent Supp and RAP projects. The developer fee is underwritten as follows:

1. For Section 221(d)(4) and Section 223(f) transactions involving LIHTCs, Borrowers may earn a developer fee payable from the tax credit equity subject to

the LIHTC allocating agency's limitations on developer fees, and in no case to exceed 15 percent of total development costs (less acquisition, reserves and developer fee), payable on the schedule allowed by the allocating agency and/or equity investor.

2. For other than LIHTC transactions, the Borrower developer fee may be up to 10 percent of the total budget (less acquisition, reserves and developer fee). This developer fee is allowed for Section 223(f) and Section 221(d)(4) transactions.
  3. On Section 221(d)(4) substantial rehabilitation, identity-of-interest (IOI) transactions with on IOI between the Borrower and General Contractor, this Developer Fee, calculated as described above, is interchangeable with BSPRA and should be listed on the HUD-92264 form as described in Chapter 3 of the MAP Guide.
- O. Consultants. RAD Borrowers may enlist development consultants to assist with the RAD application or the FHA process. Qualified consultants can expedite the development of the proposal, improve the quality and help lower costs.

A housing consultant is defined as an individual or firm possessing experience and competence in organization and planning of housing projects, housing market evaluation and marketing, procurement of financing, evaluation and selection of attorneys, architects, building contractors, property managers, and other required participants, and preparation of applications and other necessary documents. The consultant's efforts must be directed exclusively toward serving the borrower and the interest of the tenants.

HUD will permit a reasonable fee for consultant's services to be paid out of the allowable Developer Fee as described above. The consultant's fee includes administrative and organizational services directly done by the consultant, but does not include the actual costs of the services completed by others that the consultant arranges. These services may be categorized as organizational expenses or as separate line items.

- P. Acquisition costs. Lenders may include acquisition costs for RAD projects in FHA underwriting, provided that the acquisition is an arms-length transaction that involves the PHA/owner selling the property to a distinct entity or selling the property to a LIHTC Limited Partnership. For public housing conversions, the acquisition cost may be included in the FHA underwriting, but only in the form of a seller note or a long term land lease (that is subject to cash flow).
- Q. Organization expense. Organization Expense is the cost of the services typically required for a sponsor to initiate a project, organize its planning, financing, and construction, and control and management of the construction of the project through final endorsement. Services and costs included under Organization Expense are those customary to the organization and development of projects of similar size and complexity in the locality of the proposed project. The organizational services may be performed for the owner by

experienced individuals or specialists, or they may be performed by the sponsor himself, but fees cannot be paid for services performed by a consultant. Please see Chapter 8 of the MAP Guide.

- R. Secondary financing. RAD projects may include secondary financing in accordance with Chapter 8 of the MAP Guide and any subsequent HUD/FHA guidance related to allowable hard and soft secondary debt under the Section 223(f) and Section 221(d)(4) programs. PHA Borrowers will be considered public entities and are therefore exempt from the MAP Guide provision restricting seller-take back notes to cases where the loan is less than 50 percent of the mortgageable cost.
- S. Cost certification. Cost certification will be required in line with the specific FHA program utilized (e.g., Section 223(f) or Section 221(d)(4)). Cost certifications must account for all financing sources, including FHA and other sources. If the transaction involves less than 80% loan to cost and uses LIHTC equity, an FHA cost certification is not required. In these transactions, Public Housing and Mod Rehab owners must submit a cost certification required by the RAD program as detailed in PIH Notice 2012-32.

## **V. Streamlined Application Review Process for RAD Mortgage Insurance Applications**

To expedite the processing of RAD transactions, HUD will use a streamlined application review process for all Section 221(d)(4) and Section 223(f) transactions as detailed below. Each RAD application will be assigned to a Transaction Manager at the time of receipt of the RAD application. This Transaction Manager will review the RAD application, determine acceptability, and issue the CHAP. The Transaction Manager will hold a kick-off call including the PHA/Owner, lender (as identified in the RAD application), Hub with jurisdiction over the property, and other development team members, within 30 days of the CHAP issuance. This call will be held in lieu of the traditional FHA concept meeting. This Transaction Manager will monitor the PHA/Owner's progress toward meeting the RAD program milestones described in detail in Attachment 1, including those milestones the PHA/Owner must complete prior to submission of the FHA loan application. The PHA/Owner will work with the MAP lender to prepare and submit the FHA insurance application. Processing of the application will follow these guidelines:

- A. Designated Underwriter (DU). At the time of submission of the FHA insurance application, each RAD transaction will be assigned to a Designated Underwriter. This individual may be the same as the Transaction Manager who will perform the initial RAD application review, or this may be a different individual who will coordinate with the Transaction Manager. This Designated Underwriter will oversee the underwriting of the FHA transaction, and will be located in one of the Hub offices designated as processing centers for RAD.
- B. One stage applications. All RAD FHA applications will be one-stage, Direct-to-Firm applications, including Section 221(d)(4), unless the FHA lender requests to submit a Pre-Application for a Section 221(d)(4) transaction.

- C. Submission of FHA insurance application. Lenders will submit the FHA insurance application electronically. The lender will submit the lender Underwriter's Narrative via email to a central repository at [RADFHA@hud.gov](mailto:RADFHA@hud.gov). Within five business days of receipt of the Underwriter's Narrative, the Designated Underwriter will contact the lender to request submission of a disc or flash drive containing electronic copies of all insured loan application materials, along with a single original and one hard copy of the application. Lenders must submit the hard copy of the application, including required signatures, within 5 business days of receipt of the Transaction Manager request.
- D. Application completeness. The FHA lender is responsible for ensuring that the application, including the lender's Underwriting Narrative and exhibits, are complete at submission. HUD may reject the application within 5 business days if it is determined that the application is materially incomplete or does not meet program requirements.
- E. Firm Commitment processing and RAD milestones. RAD firm commitment underwriting will focus on risk mitigation and minimize the number of reviews. Under the first (competitive) component of RAD, the Mod Rehab Owner or PHA will be selected from the applicant pool and will be issued a CHAP, or Commitment to enter into a HAP Contract. The CHAP is the document provided to the PHA or Mod Rehab Owner for projects that have been selected during the RAD competition under the first component of the Demonstration that describes the terms under which HUD will enter into a HAP contract with the project owner. The CHAP is issued after projects have been selected to participate in RAD. Once the CHAP is issued, the owner/PHA must meet a series of milestones with specific deadlines, or risk forfeiture of the RAD CHAP. Lenders are urged to become familiar with the required milestones. See Attachment 1 to this ML.
- F. Streamlined processing for Section 223(f) RAD transactions. For a Section 223(f) application on a RAD project (with or without Low Income Housing Tax Credits), application formats used for the Low Income Housing Tax Credit (LIHTC) Pilot (see ML 2012-01), including the electronic HUD forms, auto-generated wheelbarrow and sources and uses reports, and streamlined application exhibits, are acceptable. The Designated Underwriter will review the firm commitment application and exhibits and complete the processing, except for the environmental review which will be conducted by the Hub environmental reviewer (usually an appraiser). The Designated Underwriter will not delegate portions of the application review to HUD technical staff except in rare cases when such review is necessary to assist with mitigating risk, with resolving complex transaction issues and/or with compliance with regulatory requirements. The Designated Underwriter will conduct the review in accordance with the following guidelines:
1. Narrative and sources and uses review. The Designated Underwriter will review the lender's Underwriting Narrative, application exhibits and forms. The Designated Underwriter is expected to perform all reviews and process the application using the procedures outlined in this ML.

2. Architectural, Engineering, Cost and Mortgage Credit review. The Designated Underwriter will review the third-party consultant's analysis of the required plans and specifications, scope of work and rehabilitation costs, except in rare cases when review by technical staff will assist with mitigating risk, with resolving complex transaction issues and/or with compliance with regulatory requirements, or in cases where the lender has identified significant repair work that: a) the Designated Underwriter believes may be in excess of the permitted rehabilitation limits under the 223(f) program, or the higher limits (up to \$40,000 per unit) allowed under the LIHTC Pilot, or b) where temporary relocation of project residents is beyond a 30 day period. Unless the application qualifies for the LIHTC pilot, the standard Section 223(f) repair cost limitations will apply. The Designated Underwriter will engage the HUD Architect to review Fair Housing Act compliance and other accessibility issues, as necessary. The Designated Underwriter will review the lender's mortgage credit analysis. The Designated Underwriter will ensure that, for projects that received competitive rating points for committing to pursue and achieve an industry recognized green building standard, than the third part consultant represents that the plans and specifications will reasonably achieve the specified green building standard.
3. Appraisal/Valuation review by the Designated Underwriter of RAD transactions will involve the following steps:
  - a. The appraisal review should note the Borrower will be requesting conversion of the existing rental assistance at the project to either PBRA or PBV assistance, for a term of 15 to 20 years. Please refer to Section IV.I.5 for appraisal guidance related to project rents.
  - b. Unlike the rent levels, which are restricted by FMRs and/or the current subsidy at the property, project expenses are not pre-set by RAD. As discussed in Section IV.I.6, the appraisal should detail appropriate operating expenses, and the lender's underwriting should carefully justify the reasonableness of the operating expenses used in the Firm Commitment underwriting. The Designated Underwriter will review these expenses against the lender's justifications to determine their acceptability.
  - c. A USPAP compliant third-party appraisal is required. Jurisdictional exceptions may be taken as required. The appraiser may utilize the "band of investment" approach on appraisals for RAD transactions. Review of the appraisal and income/expenses is delegated to the lender and the results of the lender's review will be included in the Underwriter's Narrative. The Designated Underwriter will perform a desk review of the appraisal and the lender's appraisal analysis. This review will not be assigned to the HUD appraiser unless the Designated Underwriter requires specific technical assistance. The

Designated Underwriter review of the third-party appraisal will address the appropriateness of the income and expense figures used in the project underwriting. The Designated Underwriter may consult iREMS to evaluate operating expenses on Section 8 properties.

- d. The Designated Underwriter may request the HUD appraiser to review the third-party appraisal, and the lender's appraisal analysis in certain limited cases to provide an analysis of the discrepancy between the expense conclusions in the third party appraisal or the lender's underwriting and the comparable expenses for assisted projects in iREMS.

4. Project site visit. The Designated Underwriter is required to perform a site visit to the project to assess whether: a) the proposed repair work and reserve for replacement schedule is appropriately estimated and sufficient to meet the project's physical needs, over the term of the loan; and b) the Borrower and management company have the capacity to effectively manage the property. Due to limitations on travel funding and the location of Designated Underwriters in various offices, the Department may delegate this site visit to HUD staff proximate to the property.

G. Section 221(d)(4) Reviews. All Section 221(d)(4) applications may be Direct-to-Firm transactions. If the project involves LIHTCs, the LIHTC flexibilities in the MAP Guide will apply, including deferred submission of plans and specifications. The Designated Underwriter will review the firm commitment application and determine if and when reviews from technical staff are warranted to mitigate risk. As in Section 223(f) transactions, a MAP compliant appraisal is required, but review of the appraisal is delegated to the MAP lender.

H. Role of HUD Headquarters. Staff in the Headquarters Office of Multifamily Housing will track and monitor RAD projects with proposed FHA insured financing and will provide guidance to Designated Underwriters in participating offices to resolve issues and help manage the pipeline. The role of the Headquarters staff will be as follows:

1. Hold bi-weekly tracking calls with participating Designated Underwriters;
2. Provide guidance to Designated Underwriters on specific transactions; and
3. Coordinate RAD conversion requirements and processes with FHA processes.

I. Issuance of Firm Commitment. At completion of application processing, the Designated Underwriter will present a brief Underwriting Memorandum with a Firm Commitment recommendation to the Hub Director. RAD transactions will be reviewed by Hub Loan Committee or the Headquarters FHA Loan Committee, as appropriate, prior to closing. The Hub Director in the jurisdiction where the project is located will sign the Firm Commitment.

- J. Closing. The closing of RAD transactions will follow the Section 223(f) or Section 221(d)(4) loan closing process described in the MAP Guide, with the following exceptions:
1. Waiver of ALTA Survey. The Designated Underwriter may recommend a waiver of the ALTA Survey for Rent Supplement transactions involving the refinance of a Section 202 Direct Loan, where HUD is the mortgagee and where the new FHA lender submits a statement certifying that there have been no material changes or additions to the structure or property boundaries since the closing of the original loan.
  2. Deferred submission of plans and specifications. RAD transactions under Section 221(d)(4) or Section 223(f) that utilize LIHTCs may follow the process for deferred plans and specifications which may be submitted prior to closing.
  3. Submission of Tax Credit Limited Partnership Agreement. The Limited Partnership Agreement for LIHTC transactions is to be submitted for review with the application for Firm Commitment, if available.
  4. The Designated Underwriter may opt to review any or all of the closing documents, or may delegate this review to HUD project management or underwriting staff.
  5. Lenders should begin preparations for closing by ordering the title and survey and by preparing the loan documents for HUD review before issuance of the Firm Commitment.
  6. For public housing projects, the RAD closing will include additional steps to formally convert the project, and its rental assistance, to the new rental assistance platform. This includes release of the Public Housing project from the Annual Contributions Contract (ACC) and Declaration of Trust. For conversions under the second component of RAD, closings will need to be coordinated closely with the PHA that will administer the PBV contract, and with HUD's Office of Public and Indian Housing, to ensure the availability of PBV assistance on the date of closing.
- K. Timing. The goal of RAD transactions under Section 223(f) and the LIHTC Pilot is to issue the Firm Commitment within 60 calendar days of submission of a complete application, and to close the loan within 90 – 120 calendar days of submission. For non-LIHTC Pilot applications, the goal of RAD transactions is to meet RAD transaction timeframes and to meet or exceed MAP Guide timeframes.

## **VI. Applicability of the LIHTC Pilot to RAD Transactions**



Any Section 223(f) RAD transactions involving LIHTC equity and meeting the below specifications may be submitted, by an approved FHA LIHTC Pilot lender, under the LIHTC Pilot, which was launched as Mortgagee Letter 2012-01. RAD transactions may be submitted under the Pilot provisions for “Projects with rental assistance” (see Section IV.A.1.b of Mortgagee Letter 2012-01). Lenders must identify in the Underwriter’s Narrative that the application is for consideration under the LIHTC Pilot.

To be eligible for the LIHTC Pilot, the RAD transaction must meet the following specifications:

- The application must be submitted by a MAP Lender that has been approved to participate in the LIHTC Pilot (previously approved or approved subsequent to publication of this ML).
- Section 223(f) acquisition and/or refinance and moderate rehabilitation transactions that meet all requirements of Mortgagee Letter 2012-01.
- Transactions may be located in any part of the country but will be processed by Multifamily Hubs designated as LIHTC Pilot processing offices.
- The RAD conversion must result in at least 90% of the project units supported by a project based rental assistance contract. The contract may be a PBRA or a PBV contract. Because the rent-setting and contract execution mechanisms for RAD projects differ from standard Section 8 PBRA HAP contract renewals, the rent-setting and contract execution mechanisms for these projects must follow the process outlined in PIH Notice 2012-32 in lieu of the process for HAP contract renewals described in Mortgagee Letter 2012-01.
- Repair work under the Pilot is authorized up to but not to exceed \$40,000 per unit in hard costs (with no adjustment for high cost areas). Architectural, and if necessary, General Contractor (GC) fees may be included within this \$40,000 per unit cap.
- Temporary tenant relocation during the repair period must be no more than 30 days.
- The transaction must be poised to meet the LIHTC Pilot time frames – with an expected processing time of no more than 120 days.

Note: only those Section 223(f) RAD projects that are eligible for the LIHTC pilot may use this \$40,000 per unit cap on repairs. All other Section 223(f) RAD projects must adhere to the repair cost limits published in the MAP Guide.

- As discussed in ML 2012-01, LIHTC pilot transactions involving repairs above \$15,000 per unit require the mortgagor to engage a licensed architect to oversee repair work; this licensed professional will determine if a GC is to be engaged.

This is consistent with the guidance in RAD for the first (competitive) component of RAD, which requires the PHA to engage a GC or to demonstrate their capacity to perform the repair work.

- The Section 223(f) financing being made available under the Pilot can be used with taxable financing or with tax exempt bonds.
- Evidence of a LIHTC award, allocation or commitment is required, as described in ML 2012-01 and subsequent Pilot instructions.
- Application submission and processing will follow the steps described in ML 2012-01, as repeated in Section III, above.

## **VII. Implementation**

This Mortgagee Letter is effective immediately.

If there are any questions and/or concerns regarding this ML, please contact Margaret S. Salazar in the Office of Multifamily Housing at (202) 402-2423. Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-877-TDD-2HUD (1-877-833-2483).

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Carol J. Galante  
Acting, Assistant Secretary for Housing –  
Federal Housing Commissioner

## **FHA Loan Processing & RAD Milestones**

RAD firm commitment underwriting will focus on risk mitigation and minimize the number of reviews. Under the first (competitive) component of RAD, the Mod Rehab owner or PHA will be selected from the applicant pool and will be issued a CHAP, or Commitment to enter into a HAP Contract.

The CHAP is the document provided to the PHA or Mod Rehab owner for projects that have been selected during the RAD competition under the first component of the Demonstration that describes the terms under which HUD will enter into a HAP contract with the project owner. The CHAP is issued after projects have been selected to participate in RAD. Once the CHAP is issued, the PHA/owner (sponsor) must meet a series of milestones with specific deadlines, or risk forfeiture of the RAD CHAP.

The CHAP and its associated milestones are not required for RAD conversions under the second component of the demonstration.

Lenders are urged to become familiar with the required milestones in Section 1.12 of PIH Notice 2012-32, summarized below:

1. Within 30 days following CHAP issuance the Owner/PHA must submit to HUD:
  - a) Accepted Lender Engagement or Commitment Letter. For FHA transactions, the letter must include language, specified by HUD, that the lender is aware of all relevant RAD policies including RAD Use Agreement provisions and ongoing requirements in the case of foreclosure or bankruptcy. The letter must include the proposed loan amount, proposed key business terms of the loan, pro forma sources and uses, and pro forma stabilized cash flow. The letter may be conditioned upon the lender's due diligence and underwriting determinations, and the lender's approval processes. If the owner/PHA has paid a cash fee associated with this Engagement Letter, the amount of that fee must be reasonable and customary at this point in a loan transaction; and a
  - b) Statement of development team capacity. This statement must identify the proposed development team members, with evidence demonstrating, as applicable, the team's recent successful experience financing, developing, rehabilitating, constructing, owning, and operating similar properties. The statement must describe teaming partner relationships, including resumes. If multiple sources of financing have been identified for the project, the development team must have experience with at least three transactions with mixed or multiple sources of financing. If, in HUD's determination, the applicant does not demonstrate it has sufficient

relevant experience, HUD may require an applicant to bolster its development team as a condition of final approval of a RAD conversion application. FHA lenders must perform an assessment of the development team capacity at this early stage to identify any weaknesses in the capacity of the development team and recommend appropriate mitigants which may include addition of a development partner with appropriate capacity.

2. Within 60 days following CHAP issuance, the Owner/PHA must submit to HUD:
  - a) The significant amendment to its Annual/Five Year Plan.
  - b) The PHA's decision whether the project will convert its assistance to PBV or to PBRA. For conversions to PBV, where the PHA does not administer a Housing Choice Voucher program, the PHA must submit a signed letter from a voucher agency evidencing their willingness to administer the PBVs.
3. Within 90 days following CHAP issuance, the PHA must submit to HUD a certification from the PHA that all industry-standard due diligence has been performed for and received by the Lender and/or other financing source. For FHA transactions, this includes completion of all MAP-compliant 3<sup>rd</sup> party reports, and the RAD PCA report. At this stage, the owner/PHA must also submit a copy of the RAD PCA report to the Department.
4. Within 150 days following CHAP issuance, the Owner/PHA must submit to HUD certification that it has applied for firm commitments of all financing. For FHA-insured financing this must be in the form of the Firm Commitment Application to FHA.
5. Within 180 days following CHAP issuance, the owner/PHA must submit to HUD a Financing Plan. Submission of the FHA Firm Commitment application to HUD at the 150 day mark will satisfy this requirement. (Please note: a Financing Plan is required for all RAD conversions of Mod Rehab properties, including those under the second, non-competitive component of RAD. The FHA firm commitment will also satisfy the Financing Plan requirement for these non-competitive Mod Rehab conversion proposals.)

If a PHA/Owner is planning to conduct permanent relocation of residents of projects converting under RAD,, it must submit a relocation plan to HUD for review, either as part of its Financing Plan or along with its FHA Firm Commitment application. See Attachment 1 of the RAD Notice (PIH Notice 2012-32).

FHA will only issue a Firm Commitment on a creditworthy transaction. If and when FHA is prepared to issue a Firm Commitment, a PHA/owner will be notified of HUD's acceptance of the Financing Plan via issuance of an FHA Firm Commitment,

which will be done in conjunction with the issuance of the RAD Conversion Commitment (RCC). The RCC will outline the key components of the planned RAD conversion and will discuss the conditions that need to be satisfied in order to close the conversion. The RCC will be a template document not subject to negotiation by the PHA or by the lender.

The PHA will have 30 calendar days from the date of issuance of the RCC to execute the RCC and return it to HUD. If the RCC is not returned in this time period, the PHA will forfeit its award.

Once the RCC is executed, HUD expects that the RAD conversion will close in a timely manner. The RCC will allow 90 calendar days (from the date the RCC is issued to the PHA) in which to close the RAD conversion transaction. The PHA and lender will need to work diligently to achieve closing within the timeframe required under this Notice in order to avoid rescission of the RCC.

The RCC will be an attachment to the recorded RAD Use Agreement. Therefore, the terms of the RCC will survive the closing.

6. Within 320 days following issuance of the CHAP (and no later than 40 days prior to closing), the FHA firm commitment, and a firm commitment for all other sources of financing required to close the transaction, must be issued.
7. Within 360 days following CHAP issuance the PHA must reach closing, upon which the RAD conversion is completed.
8. The FHA firm commitment and RCC must include a reasonable timeline for completion of all rehabilitation items acceptable to HUD. This rehab/repair period will be consistent with the form of FHA financing (Section 223(f) or Section 221(d)(4)).

In addition to the milestones described above, any CHAP awarded to applicants proposing to use 9 percent LIHTCs or tax-exempt bonds and 4 percent LIHTCs, where a reservation has not been secured at the point of RAD Application, will include additional milestones, including, but not limited to:

- A date by which the RAD applicant must have submitted an application for LIHTC or bond authority, based on the deadlines for required application and related materials (e.g., inducement resolution for tax-exempt bonds) described in the applicable QAP
- A date by which the RAD applicant must notify HUD of the decision of the credit-issuing authority, 10 days after the Notification of award described in the applicable QAP.

A PHA that fails to meet a contractual milestone will cause the CHAP to be revoked unless it has been submitted, and HUD has approved, a request for extension of the contractual deadline. The

extension request must include a justification and explain why failure to meet the milestone should not jeopardize the PHA's ability to complete the RAD conversion. Approval of extensions is at the Department's sole discretion. Extensions will not be approved if the delays resulted from factors that are within the PHA's control.