

CHAPTER 17. OPERATING LOSS LOANS

17-1.OPERATING LOSS LOANS - TO COVER OPERATING LOSSES DURING THE FIRST 2 YEARS OF PROJECT OPERATION. The mortgagor may request and HUD may insure loans under Section 223(d) of the National Housing Act (and applicable HUD Regulations for the Section of the Act under which the multifamily project is insured). Section 223(f) projects are ineligible for a Section 223(d) operating loss loan.

A.Operating loss is the difference between operating expenses and project income.

1.Includable in operating expenses are: taxes, interest, maintenance, and salaries, supplies, and other expenses for project operation.

\* 2. The following may not be included:

a.Principal payments.

b.Depreciation.

c.Payments to the reserve for replacements account.

d.Mortgagee fees and charges incurred in connection with the application for the operating loss loan.

e.Projected or anticipated losses.

f.Expenses that were funded or should have been funded from the working capital deposit, e.g., tax and insurance escrows.

g.Construction cost overruns.

h.Officers' salaries.

i.Bad debt or write-offs as a result of an identity of interest tenant. \*

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(17-1) B. Determination of the Operating Loss Period

1.The loss period begins the day after the cost certification cut-off date. (The National Housing Act

refers to the date of completion, as determined by the Secretary. Since costs as of the cut-off date are considered in the original mortgage computation, the date of completion referenced in the law has been interpreted to mean the completion of development. Therefore, the cut-off date, not the final completion date is used in determining the loss period.)

2.The maximum loss period is 2 years.

C.Applications within the 2-year period may be made, if necessary, to prevent foreclosure or assignment.

D.Deadline for Application is 3 years after the end of the operating loss period defined in B above.

E.Amount and Amortization of Loan

1.The mortgage will be a principal obligation stated in multiples of \$100.

2.The amortization period of the loan may not exceed the unexpired term of the original mortgage.

F.Maximum interest rate of the loan is set by agreement between the mortgagee and mortgagor.

17-2.DETERMINATION OF MAXIMUM INSURABLE LOAN. The maximum insurable loan is limited to the lesser of:

A.Amount requested.

B.Amount of operating loss established by HUD's review.

C.Maximum loss supported by debt service limitation.

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GENERAL REQUIREMENTS FOR APPROVAL.

A.An allowable loss has been experienced.

B.The mortgagor entity must have owned the project during the loss period.

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(17-3) C. All funds in the operating deficit escrow, if applicable,

have been disbursed.

D.All cost certification requirements have been satisfied.

E.The sponsor meets HUD's standards for project management.

17-4.INFORMAL, PRELIMINARY DISCUSSIONS. The mortgagor may submit a written request for informal, preliminary discussions.

A.AM, Valuation and Mortgage Credit staff and the Multifamily Division Director or designee will attend.

B.Multifamily Division Director will advise the mortgagor that only one operating loss loan may be made, even if an application is to be made for a loan covering less than the maximum 2-year period.

C.HUD determines the mortgagor's eligibility and a tentative loan amount without formal processing or without the requirement of certified financial statements from the mortgagor.

1.AM provides income and expense data to the Valuation staff.

2.The Appraiser:

a.Estimates future rentals, income and expenses.

b.Performs the following calculations:

(1)Multiply the total current approved annual rent by the estimated occupancy percentage.

(2)From the amount determined in step (1), subtract the total annual operating expenses (including reserves for replacements), taxes, annual ground rent (if leasehold) and special assessments, if any.

\* (3) Multiply the amount of net income determined in Step (2) by the applicable ratio of debt-service-to-net-income based upon the mortgagor \*

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(17-4)\*type and Section of the Act under which the project is insured.

(4)Deduct the amount of the current annual debt service requirements on the mortgage and other debt service requirements (based on 12 times the current monthly payment of principal, interest, and mortgage insurance premium), if any, from the results of Step (4).

(5) Divide the residual income in Step (4) by the debt service rate for the loan, based on the interest rate, to obtain the tentative operating loss loan.

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3. The MCE prepares a trial Form HUD-92264-A.

17-5. FORMAL SUBMISSION. Formal application requires, at a minimum, the following:

A. Submission of Form HUD-92013, Application for Mortgage Insurance, with completion of Sections A, B, C, E, F, H, I, K, L and M by the applicant.

B. Mortgagee-of-record's written statement that it has no objection to the operating loss loan when it will not be the Section 223(d) lender.

C. Financial statements of the mortgagor entity.

1. The latest financial statements, including balance sheet, operating statement, and statement of changes in financial position, if applicable, prepared by a Certified Public Accountant.

2. A signed balance sheet prepared at the end of the month preceding submission of the formal application.

3. A separate audited income and expense statement and statement of changes in financial position, if applicable, prepared by a Certified Public Accountant for the loss period for which the loan is requested.

4. If sustaining occupancy has not been established, a statement of income and expenses, projected to sustaining occupancy.

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(17-5) 5. All financial statements must contain the truth and accuracy certification and the criminal certification identified in paragraph 3-2.B.1. above.

D. Current credit reports on the mortgagor entity and all principals of the mortgagor entity.

E. Form HUD-92013 Supp with the heading information and page 2 of the form completed for all principals of the mortgagor entity.

F. If the mortgagor entity or any of its principals

have been or are delinquent on any Federal debt,  
the following information must be provided:

1. A detailed explanation from any applicant or principal with a prior or an existing Federal debt or claim.

2. A letter from the affected agency on agency stationery, signed by an officer, stating that the delinquent debt is current or satisfactory arrangements for repayment have been made.

3. The mortgagee's reasons(s) for recommendation of the applicant.

G. A combined application and commitment fee for \$3.00 per thousand dollars of the requested loan amount. (No inspection fee is required.)

H. Title requirements are the same as for the original mortgage.

17-6. PROCESSING OF THE APPLICATION. Processing will be completed simultaneously by the Mortgage Credit, Valuation, and Loan Management Branches. However, Mortgage Credit cannot complete its processing until Valuation completes the items identified in paragraph 17-4.C.2. The Director of Housing Development makes a final review.

A. Analysis of Financial Statement. The MCE sets up a separate work binder and prepares a financial statement review worksheet to include in the binder.

1. Give particular attention to the consistency and plausibility of all income and expense items for the period of the loss.

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(17-6) 2. Do not depend exclusively on figures supplied by the mortgagor's accountant.

3. The mortgagor must report income from all sources, including laundry, parking, and commercial.

4. Do not recognize that portion of an item that appears excessive.

a. Disallow items of expense associated with construction cost overruns.

b. Disallow costs credited to the mortgagor at cost certification and reconcile differences.

c. Use a copy of Form FHA-2331A, Cost Certification Review Worksheet, and Form FHA-2580, Maximum Mortgage Amount, prepared at cost certification processing as a reference when analyzing the mortgagor's submission.

5. Do not include depreciation, deposits (if any) to the reserve for replacements, principal payments (if any) and amounts spent for improvements or additions, which should properly be capitalized.

6. Do not include salaries paid to officers of the mortgagor unless the amount paid:

a. Represents cost of providing management services.

b. Is customary to the area and does not exceed the amount approved in the Management Agreement.

7. The total cost of advertising must be reduced to that specifically for the project.

8. Interest on funds borrowed to operate the project is limited to the rate approved by the Loan Management Branch when authorization was granted to the owner to make such loan.

9. Bad debts may be an allowable expense provided:

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(17-6)a. Potential income less vacancies has been reported by the mortgagor.

b. Mortgagor provides statement that all reasonable means have been exhausted to collect "rent past due."

10. Reduce the amount of loss by the initial operating deficit attributable to the loss period and for expenses that were or should have been paid from the working capital deposit

required in the original processing.

B. Credit Investigation. The MCE is to perform a complete credit investigation on the mortgagor entity following the instructions outlined in Chapter 2. Credit reports and Forms HUD-92013 Supp submitted for the principals of the mortgagor entity are to be reviewed only to assure that any delinquent Federal debt has been satisfactorily addressed.

C. Prepare Form HUD-92264-A, Supplement to Project Analysis, completing Criteria 1 and 5, and Criterion 10, "The Actual Loss," as determined by HUD review. Complete Criterion 5 as follows:

Step 1. Multiply valuation's estimate of current or projected net income by the applicable ratio of debt-service-to-net-income based upon the mortgagor type and Section of Act under which the project is insured.

Step 2. From the amount of net income determined in Step 1, deduct the amount of current annual debt service requirements on the outstanding mortgage.

Step 3. Figure the maximum operating loss loan by dividing the residual income determined in Step 2 by the debt service rate for the operating loss loan, based on the interest rate indicated in Section M of Form HUD-92013 and the remaining term of the original mortgage.

Step 4. Prepare a memorandum to the Director of Housing Development recommending approval or rejection of the operating loss loan request and obtain the concurrence of the Loan Management Branch.

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(17-6) D. Loan Management reviews the competency and responsibility of project management. A memorandum of findings and recommendations goes to Mortgage Credit for the Mortgage Credit binder.

17-7. IF SUSTAINING OCCUPANCY IS NOT YET REACHED. All or a portion of the operating loss loan proceeds will be held in an escrow by the mortgagee if sustaining occupancy has not been achieved at the time of approval of insurance for the operating loss loan.

A. If sustaining occupancy has not been reached at the time of the application, it must be evidenced that the operating loss loan proceeds will be sufficient to carry the project through to sustaining occupancy.

B. Insurance of the loan will not be approved unless paragraph A above is satisfied and there is supportive evidence providing reasonable assurance that sustaining occupancy will be reached in the near future (in most cases within 12 months).

C. The Chief, Loan Management Branch, must approve any request for the release of escrowed funds until the project is self-sustaining.

17-8. SECURITY INSTRUMENT. The security instrument must be on a form approved by the Commissioner.

17-9. FIRM COMMITMENT LETTER. The following firm commitment letter, evidencing the Commissioner's approval of the application for insurance and giving the terms and conditions upon which the loan will be insured, is prepared for the Director of Housing Development's signature.

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(COMMITMENT LETTER)

(Mortgagee)  
(Street Address)  
(City, State)

Gentlemen:

Subject: Commitment for Insurance Section 223(d)  
Sponsor:  
Mortgagor:

The Federal Housing Commissioner, acting on behalf of the Secretary of Housing and Urban Development, will endorse for insurance under Section 223(d) of the National Housing Act, and the Regulations thereunder now in effect, a mortgage note in the amount of \$ \_\_\_\_\_, to be secured by a mortgage, on the property located at \_\_\_\_\_ and consisting of approximately \_\_\_\_\_ square feet. The insurance endorsement will be subject to compliance with the requirements of the Regulations, and the terms and conditions set forth below.



1. The loan shall bear interest at the rate of \_\_\_\_ percent per annum payable the first day of each month on the outstanding balance of principal. The first payment to principal (commencement of amortization) shall be due on the first day of the \_\_\_\_ month following the month in which the mortgage is dated. The loan shall be payable on a level annuity basis in \_\_\_\_ monthly payments of principal and interest in the amount of \$ \_\_\_\_\_. The maturity and final payment date shall be \_\_\_\_ years and \_\_\_\_ months following the date of the first payment to principal (not to exceed remaining term of the original mortgage).

2. At least 15 days before the anticipated date for initial/final insurance endorsement of the mortgage note, two draft copies of each of the following documents and exhibits shall be submitted to the Commissioner. After review, the place and date of the initial/final closing will be designated, at which time the following documents and exhibits in final form shall be delivered to the Commissioner for approval:

- a. The loan must be evidenced by a supplementary note and supplementary mortgage drawn upon a HUD-approved form with security to be coextensive with the real and personal property securing the original mortgage with interest at the obtainable rate per annum to maturity on \_\_\_\_\_.

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All references to the collection of escrows for "taxes," and "hazard insurance" must be deleted from the supplementary or new mortgage.

- b. The supplementary note and the supplementary mortgage must contain a provision that a default under the original note and original mortgage will be a default under the supplementary mortgage.
- c. The original note and the original mortgage must be amended and modified by an appropriate instrument signed by the mortgagor and the mortgagee to provide that a default under the supplementary note and supplementary mortgage shall be default under the original note and the original mortgage.
- d. Title evidence must be presented covering the new loan which reflects no lien other than the lien of the first mortgage and liens accepted on the title policy insuring the first mortgage.
- e. The mortgagee, under the first mortgage, must submit

an appropriate instrument in writing consenting to the creation of the junior lien and agreeing not to exercise its option to accelerate the maturity of the note by reason of the creation of the junior lien.

f. The mortgagee of record shall furnish a letter stating that the first mortgage is current in all respects.

3. At the endorsement of the mortgage note, there shall be filed with the Commissioner copies of all instruments or agreements necessary under the laws of the applicable jurisdiction to authorize the execution of the mortgage and the closing documents, and to permit the Commissioner's regulation of the mortgagor as to rents, charges, and methods of operation. The original Regulatory Agreement may be modified to reflect the new recording date.

4. Any change in the sponsorship upon which this commitment is predicated must be requested in writing by the mortgagee on behalf of any proposed substitute sponsor, and such request must be approved in writing by the Commissioner. Any sponsor or principal (including the principals of any parent entity of such sponsor or principal), who is now or who may later become involved in this project by way of financial interest, employment or otherwise, and who has not filed a certificate with the Commissioner fully disclosing previous participation in

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HUD mortgage insurance programs, must file such certificate on the form prescribed by the Commissioner and must be approved by the Commissioner.

5. All certificates, documents, and agreements called for by this commitment must be on forms approved or prescribed by the Commissioner and shall be completed, signed and filed in the number of copies and in the manner as prescribed by the Commissioner.

6. This commitment shall terminate 120 days from the issuance date unless renewed or extended by the Commissioner. Before any renewal or extension of this commitment, the Commissioner may, at his/her option, reexamine the commitment to determine whether it shall be extended in the same amount, or amended to include a lesser amount.

7. A request for the reopening of this commitment within 90 days of its termination must be accompanied by the reopening fee prescribed by the Regulations.

8. The mortgagee must pay HUD, upon endorsement of the note for mortgage insurance, a mortgage insurance premium and will continue to pay annually under the provisions of the Regulations.

9. If, when operating loss loan is approved, sustaining occupancy has not been achieved, all or such portion of the loan as may be necessary shall be held in escrow to meet operating deficiencies until the project is self-sustaining. Release of funds from the escrow under the terms of the escrow agreement must be effected only with prior approval of HUD.

See the Regulations covering the assignment or the transfer of the insured mortgage, in whole or in part, and the transfer of the rights, privileges, and obligations under the contract of mortgage insurance.

Dated \_\_\_\_\_

Secretary of Housing and Urban  
Development

BY: Assistant Secretary for  
Housing-Federal Housing  
Commissioner

BY: \_\_\_\_\_  
Authorized Agent

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