



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

OFFICE OF HOUSING

DEC 19 2013

MEMORANDUM FOR: All Approved Mortgagees  
All Multifamily Hub Directors  
All Multifamily Program Center Directors  
All Multifamily Operations Officers

FROM:   
Mark B. Van Kirk, Director, Office of Asset Management, HTG

SUBJECT: Guidance for Servicer Watchlist Process

The Office of Multifamily Asset Management conducts Watchlist calls with its largest Servicers quarterly. Although we conduct Servicer reviews that encompass 80 percent of our portfolio, not all Servicers currently provide Watchlist information. In addition, there are significant differences in how servicers rate and classify loans for their respective Watchlist.

To provide consistency in Servicer reviews and improve the reporting process, HUD is modifying the Multifamily Delinquency and Default Reporting (MDDR) system to provide improved consistency and a clear reporting process.

We anticipate that on or about March 1, 2014, an update to MDDR will be made so that Servicers can input their Watchlist classifications into MDDR and that this input will be reviewed by HUD, both Headquarters and in the field. All delinquent and defaulted loans must be rated when any delinquent or default entries are made into MDDR. For loans not in default, Servicers are STRONGLY encouraged to input their loan ratings.

We are strongly encouraging Servicers to begin reviewing their entire portfolio immediately, using the classification definitions below. Loans rated Special Mention, Substandard and Doubtful should be considered the Servicer's Watchlist. (Pass/Watch, is included to correspond to Fannie Mae guidelines.) These terms are consistent with those used by Bank regulators, Fannie Mae and Freddie Mac, with some edits to reflect FHA unique characteristics. Servicer calls beginning in January will include a discussion on this topic, and the Servicer's process in meeting this request.

Updates to the Watchlist should be made on a quarterly basis. For most Servicers that will be March 31, June 30, September 30 and December 31. HUD will notify some servicers that updates should be on an odd month rotation due to Servicer call rotation.

Attachment 1 is HUD's current Rating Guidelines for Insured and Non-Insured projects used by HUD Project Managers. Due to use of system generated ratios and ratings, we do not expect HUD ratings and Servicer ratings to always match up. Two separate rating processes will also help facilitate communication. For Servicers that HUD holds regular Watchlist calls with, our

ratings will be shared. Other Servicers may contact the HUD Project Manager assigned to the asset to obtain their internal rating, although the rating should not be shared with Borrowers. A rough correlation between HUD and Servicer ratings is: 1-3 Doubtful, 4-5 Substandard, 6 Special Mention, and 7 Pass/Watch.

### **Servicer Watchlist Definitions**

#### **Pass/Watch**

A Pass/Watch Asset demonstrates no clear evidence of an emerging weakness that could affect its future performance. However, a Pass/Watch Asset has characteristics that require the attention of the Servicer even though such characteristics do not meet the definition for a Special Mention Asset, Substandard Asset or Doubtful Asset. Examples include, but are not limited to:

- Mortgage Loans for which documentation such as financial statements or Property inspections is past due however previous submission indicate a solid pass property,
- Moderate deferred maintenance at the Property requires action by the Borrower, but is not expected to place extraordinary stress on the operating performance of the Property; and
- Construction loans' post initial endorsement and properties in the lease-up phase are considered Pass/Watch if there has been no significant change orders and lease-up is proceeding per plan.

#### **Special Mention**

A Special Mention Asset is a Mortgage Loan that has potential weaknesses and deserves close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the Mortgage Loan or adversely affect its future performance.

A Special Mention Asset has potential weaknesses that may weaken the asset if not checked or corrected. The asset poses elevated risk, but its weakness does not yet justify a Substandard Asset classification. The Borrower may be experiencing adverse operating trends such as declining occupancy, declining revenues or increases in operating accounts. Adverse conditions, such as entry of a new competitor, may also support a Special Mention Asset rating. Nonfinancial reasons for rating a Mortgage Loan as a Special Mention Asset include management problems, pending litigation, noncompliance by the Borrower with the requirements of the Loan Documents or other material structural weakness and any other significant deviation from prudent lending practices.

The Special Mention Asset rating is designed to identify a specific level of risk and concern about asset quality. Although a Special Mention Asset has a higher probability of default than a Pass Asset or a Pass/Watch Asset, its default is not imminent. A Special Mention Asset rating is not a compromise between a Pass Asset and Substandard Asset rating and should not be used to avoid exercising such judgment.

### **Substandard**

A Substandard Asset is inadequately protected by the current paying capacity of the Property. A Mortgage Loan classified as a Substandard Asset must have a well-defined weakness or weaknesses that may jeopardize the timely repayment of the Mortgage Loan. There must be a distinct possibility that the Borrower will default under the terms of the Mortgage Loan and that a claim is possible.

A Substandard Asset has a higher probability of payment default than a Pass Asset, a Pass/Watch Asset or a Special Mention Asset, or it has other well-defined weaknesses. A Substandard Asset requires more intensive supervision by the Servicer. A Substandard Asset is generally characterized by current or expected unprofitable operations, inadequate debt service coverage, inadequate liquidity or marginal capitalization. A loan may still be rated as a Substandard Asset even though that Mortgage Loan is in default, but must have a clear path to correct any deficiencies in a short period of time.

Properties with low REAC scores reflecting serious maintenance issues and/or underfunded Reserve for Replacement Accounts should at a minimum be considered Substandard.

### **Doubtful**

A Doubtful Asset has all the weaknesses inherent in a Substandard Asset with the added characteristic that the weaknesses make resolution highly questionable and improbable on the basis of currently existing facts, conditions and values. Resolution via Transfer of Physical Assets, capital injections and refinancing would still result in a doubtful classification, unless HUD approval has been granted, but the transaction has not yet closed.

A Doubtful Asset has a probability of a claim being submitted within the next year. A Borrower associated with a Doubtful Asset lacks the resources or desire to resolve a default.

### **Servicer Actions**

Servicers are expected to take actions in an attempt to mitigate issues that resulted in the inclusion of the property on their Watchlist. The MDDR update will provide a listing of potential actions the Servicer may take to return the property to a Pass classification. This list is being refined and HUD is open to modifying, adding or deleting the following potential actions:

- Contact owner to discuss how they would cure issues
- Contact owner's agent to discuss how they would cure issues
- Propose or discuss a supplemental or operating loss loan
- Propose or discuss a Transfer of Physical Assets (sale of property)
- Propose or discuss a partial payment of claim
- Propose or discuss a prepayment
- Propose or discuss a refinance
- Propose or discuss a modification (Interest Rate Reduction)
- Review Reserve for Replacement account usage and impact on cash flow

- Propose or discuss a release of residual receipts to cure the default
- Request Monthly or quarterly financial information
- Require the owner to obtain a PCNA
- Contact HUD Project Manager for proposed Action Plan requirements

Please contact Norman Dailey at [Norman.Dailey@HUD.gov](mailto:Norman.Dailey@HUD.gov) (202-402-8371) or [Lauryn.K.Alleva@HUD.gov](mailto:Lauryn.K.Alleva@HUD.gov) (202-402-2609) if you have any questions.

Cc: Cindy Bridges  
Eileen Grey, Mortgage Bankers Association  
Norman Dailey  
Lauryn Alleva

## ATTACHMENT 1

**HUD Internal Rating Guide for Project Managers**

1	a. High likelihood of Full Claim within 6 months.
2	a. Request for Partial Payment of Claim or OAHF restructure has been received.
3	<p><b>Any one of the following:</b></p> <ul style="list-style-type: none"> <li>a. TPA required to resolve identified issues, physical and/or financial and no TPA transaction has been started</li> <li>b. Current only through owner contributions – non-tax credit</li> <li>c. High probability of Full Claim or request for a Partial Claim in 6 months – 1 year</li> <li>d. PASS/REAC below 30 Must remain a 3 until new inspection or refinance</li> <li>e. Owner or property is in Bankruptcy or Receivership.</li> </ul>
4	<p><b>Any one of the following:</b></p> <ul style="list-style-type: none"> <li>a. Delinquent three or more times in the last year</li> <li>b. SOI Category/Stage is Execute - Require or Execute - Enforce (Uncooperative owner)</li> <li>c. Current only through owner contributions – tax credit</li> <li>d. SOI - Qualitative Assessment Score (QAS) &gt;2.00</li> </ul>
5	<p><b>Any one of the following:</b></p> <ul style="list-style-type: none"> <li>a. Economic vacancy greater than projected or expenses higher than expected.</li> <li>b. Audited financial statement shows DSC below 1.0 and owner is <b>NOT</b> taking corrective action via Action Plan, refinance, modification or moving to sustaining occupancy (if new construction) to increase DSCR; Not applicable if PM analysis shows DSCR calculation in FASS is wrong</li> <li>c. PASS between 30 and 59 and owner has <b>NOT</b> certified issues identified in the last inspection have been corrected</li> <li>d. Open Referral to DEC</li> <li>e. MROC Red and SOI Category/Stage is Investigate or Execute Recommend Ex. Monthly Accounting Reports have not been requested, received, or reviewed</li> <li>f. If new construction indicator Y and Monthly Accounting Reports are not requested or received</li> <li>g. Viable TPA is in process to resolve problems</li> </ul>
6	<p><b>Any one of the following:</b></p> <ul style="list-style-type: none"> <li>a. PASS score 30-70, but ownership resolving problems (certified if under 60) and addressing why situation was allowed to occur (Includes PASS/REAC under 30 refinanced)</li> <li>b. SOI - Qualitative Assessment Score (QAS) such that <math>1.5 &lt; QAS \leq 2.00</math></li> <li>c. MOR is less than Satisfactory</li> <li>d. OAHF Watch List Contract</li> </ul>

7	<p><b>Any one of the following:</b></p> <ul style="list-style-type: none"> <li>a. If new construction indicator Y and monthly accounting reports show sound operations and ahead of underwritten projections, but occupancy is still not sustaining</li> <li>b. Refinance of a previous non-insured property. Must stay as a Rating of 7 until review of 6 months of Monthly Accounting reports (MAR)</li> <li>c. MROC Red/Yellow and management or ownership has minimal HUD experience</li> <li>d. DSC is greater than or equal to 1.0 but less than 1.15, and DSC has declined from that reported in prior year's Audited Financial Statements (AFS)</li> <li>e. SOI – Qualitative Assessment Score QAS such that <math>1.00 &lt; QAS \leq 1.50</math></li> <li>f. DSCR is less than 1.0 and the owner is taking corrective action via Action Plan, refinance, modification or moving to sustaining occupancy (if new construction) to increase DSCR, but 6 Months of MAR post corrective action have not been received/reviewed.</li> </ul>
8	<ul style="list-style-type: none"> <li>a. If Red MROC, Occupancy is over 95% or exceeds projections or market comps by 5%, and</li> <li>b. IOI Management Company</li> <li>c. For seasoned properties DSC over 1.15</li> <li>d. MROC Yellow Properties Over \$25 million that have no other attributes that would lower rating</li> <li>e. MROC Green, but two sub-categories are non-green</li> <li>f. FASS DSCR of less than 1.0 is wrong due to FASS handling of transactions</li> </ul>
9	<ul style="list-style-type: none"> <li>a. If Red MROC, Occupancy is over 95% or exceeds projections or market comps by 5%, and</li> <li>b. For seasoned properties DSC over 1.15</li> <li>c. Experienced owner, no significant flags, has other high performing HUD insured properties</li> <li>d. Highly Experienced Non-IOI Management Company</li> <li>e. MROC Yellow Property under \$25 million that have no other attributes that would lower rating</li> <li>f. MROC Green, but one sub-category is non-green</li> </ul>
10	<ul style="list-style-type: none"> <li>a. Occupancy and expenses better than or equal to projections or market comps; SOI - Qualitative Assessment Score (QAS) <math>\leq 1</math>; All MROC sub-categories must be Green AND DSCR must be greater than or equal to 1.15 in FASS.</li> </ul>