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

OFFICE OF HOUSING

APR 17 2015

MEMORANDUM FOR: Industry Partners
All Multifamily Regional Center/ Hub Directors
All Multifamily Satellite Office/ Program Center Directors
All Multifamily Operations Officers
Office of General Counsel

FROM: Benjamin T. Metcalf, Deputy Assistant Secretary for Multifamily Housing Programs, HT

SUBJECT: Clarification of Policy Surrounding Interest Rate Reductions

On April 19, 2013, the Department provided guidelines to HUD field offices regarding processing Interest Rate Reduction (IRR) requests. The Department provided a memorandum clarifying this policy and updating prior guidelines on July 26, 2013 (attached). The purpose of this memorandum is to address stakeholder feedback the Department has received and to further clarify the Office of Multifamily Housing's procedures for treatment of debt service savings as a result of an IRR in certain circumstances. The Office of Asset Management and Portfolio Oversight will continue to oversee this process.

This memorandum neither applies to an IRR request that requires HUD to waive prepayment penalties, nor overrides lockout provisions to avoid a mortgage insurance claim. Refer to Chapter 14 of HUD Handbook 4350.1, *Multifamily Asset Management and Project Servicing*, and Mortgagee Letter 87-9, *Mortgage Prepayment Provisions for HUD-insured and Coinsured Multifamily Projects*, which have detailed requirements for processing such a waiver request.

BACKGROUND:

Due to historically low interest rates, and as an alternative to a refinance under Section 223(f) or Section 223(a)(7), a mortgagor may request a reduction of the interest rate on their existing multifamily mortgage loan thereby significantly improving the property's cash flow. An IRR, unlike a loan modification, does not alter the loan documents or any terms of the loan other than the interest rate.

Historically, the Department has not considered reductions in interest rates for multifamily insured loans except to avoid a mortgage insurance claim. However, due to historically low interest rates, the Department has seen a significant increase in the number of mortgagors requesting a reduction in the mortgage loan's existing interest rate whose mortgage loans are not in default.

The increase in IRR requests resulting from the current sustained period of low interest rates has resulted in some questions as to how the IRR process interacts with other policies and actions taken on certain mortgages, particularly those under the Section 202 and 223(f) program.

202/223f DEBT SERVICE SAVINGS:

Borrowers may realize significant savings in debt service resulting from an IRR. For Section 202 and Section 223(f) loans, debt service savings may be used for operation of the project or deposited in the project's reserve for replacement account. Any debt service savings that is not used for operations or deposited in the project's reserve for replacement account flows directly to residual receipts and is subject to sweep.

In order to deposit debt service savings into a property's reserve for replacement account, the borrower must present a Capital Needs Assessment (CNA) that confirms that additional deposits into the reserve for replacement account are warranted. A new CNA is not required to fulfill this requirement. An existing CNA may be used to substantiate additional deposits, so long as those deposits are justified by needs identified in the initial 10 year window of the CNA. Alternatively, the borrower may obtain and use a new CNA to establish reserve for replacement levels.

SUBSEQUENT REFINANCING OF SECTION 202 MORTGAGES

Under the Department's current guidelines, a project with a Section 202 mortgage retains its eligibility to renew under Option Four of the *Section 8 Renewal Policy Guidebook ("Renewal Guide")*[1] and retains its exemption from debt-restructuring under MAHRA through a first refinancing. It loses that exemption and is subject to Mark-to-Market restructuring if it is refinanced a second time. A non-profit owner of an exempt property may use debt service savings resulting from a refinance for any project-based purpose. Loss of the exemption results in a review of the property's budget, with the possibility of a rent reduction if rental income exceeds operating costs of the property.

For the purposes of this policy, an IRR does not constitute a refinancing action. Thus, a property with a Section 202 mortgage that has refinanced once and subsequently undergoes an IRR will retain its current status with regard to refinancing and exemption status.

USING OPERATING OR RESERVE FUNDS FOR AN IRR

In order to obtain an IRR, certain processing fees must be paid to the Department. Non-profit organizations may borrow funds from the operating or reserve account of the property to pay the fees associated with getting an IRR. The borrowed funds must then be repaid with the savings realized as a result of the IRR. For-profit mortgagors requesting an IRR may not borrow funds from the operating or reserve account of the property to pay associated fees.

MODIFICATION OF A SECURITY INSTRUMENT

For IRR-only transactions, a modification to the Security Instrument is not necessary in instances when this document does not reference the interest rate (e.g., the 2011 and 2014 versions), unless there is a state-specific addendum that includes the interest rate, as in Illinois. However,

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[1] The Section 8 Renewal Policy Guide may be accessed at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/mfhsec8.

HUD will require lenders in such cases to certify that the FHA-insured loan remains in first lien position.

A HUD sample form of certification of continued first lien priority will be issued in the future, which will be collected (once) as an exhibit to the IRR submission package. Lenders are at liberty to conduct any due diligence and impose additional lender requirements necessary to make that certification. Please note that HUD will accept a title policy endorsement in lieu of the certification.

The guidelines in this memorandum are effective immediately. Please contact Jen Larson at (202) 402-7141 (Jennifer.L.Larson@hud.gov) if you have any questions or concerns.

OFFICE OF HOUSING

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WASHINGTON, DC 20410-8000

JUL 26 2013

MEMORANDUM FOR: Industry Partners
All Multifamily Hub Directors
All Multifamily Program Center Directors
All Multifamily Operations Officers
Office of General Counsel

FROM: Marie D. Head, Deputy Assistant Secretary for Multifamily Housing Programs, HT

SUBJECT: Revised Guidelines for Processing Interest Rate Reduction Requests

On April 19, 2013, the Department provided guidelines to HUD field offices on processing interest rate reduction requests. The April 19th memorandum has generated significant interest by the industry as an alternative to refinancing under Section 223(a)(7). The expected high volume has also raised some concerns and questions that were not anticipated when the April 19th memorandum was first rolled out. The purpose of this memorandum is to update the prior guidelines for processing requests by mortgagees to reduce the interest rate on an insured mortgage loan and to further clarify the Office of Multifamily Housing's procedures for processing requests to reduce the interest rate and re-amortize the loan. The Office of Asset Management will continue to oversee this process.

This memorandum does not apply to an Interest Rate Reduction request that requires HUD to waive prepayment penalties or override lockout provisions to avoid a mortgage insurance claim. Refer to Chapter 14 of HUD Handbook 4350.1, *Multifamily Asset Management and Project Servicing*, and Mortgagee Letter 87-9, *Mortgage Prepayment Provisions for HUD-insured and Coinsured Multifamily Projects*, which have detailed requirements for processing such a waiver request.

BACKGROUND:

Due to historically low interest rates, and as an alternative to a refinance under Section 223(f) or Section 223(a)(7), a mortgagor may request a reduction of the interest rate on their existing multifamily mortgage loan; thereby significantly improving the property's cash flow. Historically, the Department has not considered reductions in interest rates for multifamily insured loans unless it was requested to avoid a mortgage insurance claim. However, due to historically low interest rates, the Department has seen a significant increase in the number of mortgagors whose mortgage loans are not in default, request a reduction in the mortgage loan's existing interest rate.

PROCESSING GUIDELINES:

Mortgagees and mortgagors may negotiate whether it is in the best interest of the project to request a reduction in the interest rate. A reduction in the interest rate will adjust the amount of the payments in the amortization schedule. For mortgages meeting the guidelines described in this memorandum, new or revised lockout and prepayment terms may be added to allow the mortgage to be re-securitized with Government National Mortgage Association (GNMA). This may include notes with no prior lockout and prepayment terms. The maturity date and other mortgage loan terms (e.g., the principal) should not be affected. Hub/PC Directors are not authorized to change the maturity date.

Transactions subject to lockout provisions may not request a reduction in the interest rate prior to expiration of the lockout period. Many properties have prepayment penalties after the lockout period. With current historically low interest rates, many Borrowers and Lenders may agree to a reduction in the interest rate, even with significantly high prepayment penalties. Such prepayment penalties may not be added to the loan balance.

This Memorandum does not apply to Section 202 loans, except those already refinanced under an FHA-insured program, most typically Section 223(f). Previously refinanced Section 202 projects that participate in the Interest Rate Reduction program will remain exempt from the Multifamily Assisted Housing Reform and Affordability Act (MAHRA) of 1997. If, however, the previously refinanced Section 202 project refinances their existing loan with an FHA-insured mortgage, the exemption will be lost. For properties with a debt service savings account that has not been abolished, the debt service savings may continue to be paid into such account. For all other properties, the debt service savings that result from an Interest Rate Reduction transaction will remain in the project's operating account. If there is surplus cash at the end of the year, the excess would be transferred to the Residual Receipts account if there is a Section 8 HAP contract in place. In addition, at the next Section 8 HAP contract budget-based renewal, the "current" (i.e., lower) debt service would be used in all calculations.

Consistent with FHA's long-standing practice, Lenders/Servicers are permitted to pay for all or a portion of the Borrower's prepayment penalties through funds generated from Trade Profit (also known as "premiums" or "marketing gain"). Such approval is subject to the following conditions:

- No other Borrower costs may be paid by the lender or its affiliates without prior written permission from HUD. Without approval, such payments are considered a prohibited "inducement" and may result in referral for enforcement action. Nominal excess amounts of Trade Profit may, with disclosure and permission, be deposited into the project's Reserve for Replacement account.

- Excess Trade Profit may be retained by the lenders (subject to the disclosure requirements of Mortgagee Letter 2011-5, *Revised Audited Financial Statement Reporting Requirements for Supervised Lenders in Parent-Subsidiary Structures and New Financial Reporting Requirements for Multifamily Mortgages*, and the associated questions and answers, posted at http://portal.hud.gov/hudportal/documents/huddoc?id=gna_mtgeeltr11-05.pdf). This Mortgagee Letter requires disclosure of Trade Profits greater than 5 percent, including any such funds used to pay prepayment penalties.

- If the Trade Profit is being used to pay project expenses, fund the Reserve for Replacement account or the mortgagee is waiving normal expenditures, full disclosure of all anticipated project Trade Profit must be disclosed to the Borrower and HUD. A Sources and Uses statement included as part of a Financing Plan must detail the anticipated amount of Trade Profit and amounts used for the prepayment penalty and/or other project expenses associated with the mortgage note.

No advances or loans from the Reserve for Replacement account should be made for completion of an Interest Rate Reduction. A project non-servicer related cost allowed under the Section 223(a)(7) program may be funded by the Reserve for Replacement account for an Interest Rate Reduction but only in conjunction with an analysis of the account using a Physical Condition Needs Assessment (PCNA). Servicers should not be rate-locking mortgages until after HUD approval, thus their exposure should be minimal. Servicers should look to the trade premium or Trade Profit to cover third-party costs or other costs of doing business.

PROCEDURES:

Mortgagee Responsibilities:

Mortgagees should submit a package to their local Hub/PC Director requesting an Interest Rate Reduction. The package submitted to the local HUD Office for review should be sent in accordance to the instructions listed below:[1]

Current Loans:

Current loans are defined as those loans that have not been in financial or technical default within the past 24 months. The submission package for current loans must include:

- A summary of the transaction detailing the projected change in interest rate.
- A certification from the lender that they will obtain GNMA approval for prepayment of the security holders, prior to implementation of any Interest Rate Reduction.
- Debt Service Coverage Ratio (DSCR) analysis at the estimated interest rate for the revised loan.

[1] Servicers will be notified when a package has been approved or has been forwarded to Headquarters. If the loan has not yet been locked, Servicers may deliver final executed documents representing the locked rate and with attorney certification of no changes to the approving official. If the difference between the expected rate and the final rate affects the Debt Service Coverage Ratio negatively by more than .10 or takes it below 1.05, then communications between the Servicer, Hub Director and Headquarters, if necessary, must occur to ensure approval is still appropriate. Mortgagees should receive Hub executed documents within 5 business days after receipt of final documents.

- Debt Service Coverage Ratio (DSCR) analysis at the estimated interest rate for the revised loan.

- A Sources and Uses statement prepared for the Borrower. Third party lender costs such as attorney fees, GNMA, title and recording costs must be disclosed whether paid by the lender or Owner. Such costs may not be added to the principal.

- If Trade Profit is being used for something other than mortgagee costs or the mortgagee is waiving normal costs (interest), a full disclosure of the amount of Trade Profit must be made to the Borrower and HUD.

- Most recent interim and year-end financial statements.

- Draft mortgage documents initially prepared by outside counsel for the Interest Rate Reduction request to be reviewed by local HUD Office of General Counsel (Field counsel).

- A PCNA is required if the project's final endorsement was more than 10 years from date of the Interest Rate Reduction request or if the current PCNA is older than 10 years. A PCNA can be paid for out of the project's Reserve for Replacement account. The lack of sufficient funds to pay for a PCNA is sufficient reasoning for not completing an Interest Rate Reduction and instead looking at alternative solutions. Hub or Program Center Directors may require a PCNA for projects where a PNCA is not yet 10 years old, based on the age of the property, Real Estate Assessment Center (REAC) scores and/or HUD's staff personal knowledge of the property.

- A prepaid envelope for returning executed documents to the mortgagee for filing.

The documents to be provided to local Field Counsel (in draft and final form at the appropriate stage in the process[2]) include the following:

- Modification of Note.
- Modification Agreement (modifying the Deed of Trust/Mortgage). (The Final is either certified by the title company or stamped by the recorder's office with the date of recording and document number.)
- Pro Forma/Final date-down title policy endorsement to bring the policy forward to the date of the modification, including an ALTA 11-06 Mortgage Modification Endorsement to confirm continued first mortgage status post-modification and no intervening recorded liens or encumbrances.

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[2] Upon submission of the Interest Rate Reduction, the local Hub/PC must route the draft documents to local Field Counsel for review. After FHA approval and recordation, the local Hub/PC must send a copy of the final, executed documents to local Field Counsel for their files.

- A current authorizing resolution and incumbency certificate of Borrower and any general partner or managing member, as appropriate, confirming the organizational documents are current and have not changed, Borrower's approval of the modification terms and the signatory authority of Borrower's representative to execute the modification documents.

- A certification of changes from Borrower's counsel that no additional changes will be made prior to execution and/or recording of the revised documents after local field counsel has reviewed preliminary documents as part of the approval process and final documents are submitted post approval. (See HUD Handbook 4350.1, REV-1, Chapter 13, Appendix A-12 for sample language.)

- A certification from the lender that they will obtain GNMA approval for prepayment of the security holders, prior to implementation of any Interest Rate Reduction.

- Verification from GNMA's online database that the loan is not subject to a lockout.

- Executed Interest Rate Reduction Request Checklist (except OGC confirmation section).

Field Counsel may also determine that additional documents (e.g., Borrower and Principal organizational documents to verify signing authority or an opinion from the Borrower's attorney as to the execution and validity of the documents) are necessary to effectuate the Interest Rate Reduction in a particular jurisdiction or for a particular transaction. Accordingly, the local Hub/PC should consult with Field counsel early in the process to see what additional documents may be necessary to complete the legal review.

Defaulted Loans:

Defaulted loans are defined as those loans that are, or have been in financial or technical default within the last 24 months. For these loans, the following must be included in the package to the local Hub/PC:

- A PCNA and discussion of Reserve for Replacement account adequacy is required. The Multifamily Hub Director is delegated the authority to waive the PCNA requirement if the project was recently constructed or substantially rehabilitated, or a PCNA was conducted within the past 5 years, and the project is in good physical condition as documented by REAC scores and/or HUD's staff personal knowledge of the property.

- An explanation of specific problems, events, and trends that caused or were contributing factors to the default and how this transaction will resolve them.

- An explanation of where funds will be obtained to bring the loan current, fund the Reserve for Replacement account and resolve any outstanding payables.

Field Office Responsibilities:

Utilizing the attached checklist, the Hub/PC shall review the package submitted by the mortgagee to ensure compliance with policy. In addition, the Hub/PC shall complete the following:

- Verify that the Owner is in compliance with all business agreements. If the project is not in compliance with its business agreements, the mortgagor/mortgagee must show how this transaction will bring the project into compliance.
- Review Management and Occupancy Reviews (MORs) and REAC physical inspection reports and confirm that all open issues have been satisfactorily addressed.
- Review financial statements to ensure that the revised loan will have a DSCR greater than 1.05.
- Review the Sources and Uses to verify that lender costs are disclosed and reasonable.
- Review GNMA's online database to verify that the loan is not subject to a lockout. https://structuredginniemaes.ginnienet.com/multifam/. No recommendation for approval may be generated until **AFTER** the lockout has expired.
- Verify that there have been no unauthorized Owner distributions.
- If a PCNA is required, determine that the Replacement for Reserve account is adequately funded and that annual contributions are sufficient to address future needs.
- Review documents to effectuate the change in rate and route drafts to field counsel. (Field Counsel must review the documents specified in this memorandum and the Hub/PC must obtain written confirmation from field counsel that the provided documents are acceptable to effectuate the Interest Rate Reduction).
- If applicable, prepare a memorandum to the Director, Office of Asset Management, in Headquarters recommending approval of the transaction, including any justification for the use of the Trade Profit for purposes other than prepayment penalties or third party lender costs.

Interest Rate Reduction Approval Process:

For current loans (defined above) and where there is **NO** request for use of the Trade Profit for anything other than mortgagee costs, Hub Directors are delegated the authority to approve and execute documents to effectuate the Interest Rate Reduction. Actions taken by Hub Directors consistent with this memorandum are ratified and confirmed. Hub/PC staff should complete the checklist and prepare a memorandum recommending approval of the Interest Rate Reduction to the Hub Director. The Hub Director will prepare and send the approval letter to the lender. It is expected that once a full packet has been submitted to the Hub/PC for review by the Servicer, the final recommendation should be processed by the Hub Director within 20 business days of receipt.

After the transaction has closed, a copy of the approval memorandum and the executed checklist should be forwarded to the Deputy Director, Office of Asset Management in headquarters and local field counsel, until further notice.

For defaulted loans (defined above) or loans in which the Trade Premium will be used for other than prepayment penalties or lender costs, a memorandum should be forwarded to the Director, Office of Asset Management in headquarters, recommending approval of the Interest Rate Reduction, along with the completed and executed checklist, documents required for execution of the Interest Rate Reduction that include HUD Notary blocks reflecting District of Columbia requirements, and a prepaid envelope addressed for return to the mortgagee.

The mortgagee must send a copy of the recorded documents to the Hub/PC Director for their files. The Hub/PC Director is responsible for forwarding a copy of the recorded documents and mortgage note with the new payment terms to the Director, Office of Multifamily Insurance Operations in headquarters and local field counsel, and for ensuring that a copy of the documents are included in the Washington Docket.

GNMA PROCESSING GUIDELINES:

The Borrower and mortgagee must remain cognizant of GNMA processing requirements for the Interest Rate Reduction and (as applicable) resolve any issues identified by GNMA prior to final execution of the Interest Rate Reduction documents by the Department. GNMA's prior approval is not a prerequisite for FHA preliminary approval of the Interest Rate Reduction. However, the Interest Rate Reduction cannot be implemented (i.e., final execution) without a GNMA Liquidation Clarification letter, or other written confirmation that GNMA has approved prepayment. If there are questions about these processes or demonstrating compliance with GNMA requirements, the Borrower and mortgagee should contact their GNMA representative.

The guidelines outlined in this memorandum are effective immediately. Please contact Norman Dailey at (202) 402-8371 if you have questions and/or concerns.

Cross References:

Chapter 14, HUD Handbook 4350.1
Mortgagee Letter 87-9
Mortgagee Letter 2011-5

Attachment:

Interest Rate Reduction Request Checklist

INTEREST RATE REDUCTION CHECKLIST

Submission from Servicer:

Date Submission received from Servicer: ____________

Y/N

_____ Summary of the transaction that includes:

- If the Trade Profit will be used for other than mortgagee costs.
- If project is in non-compliance with HUD business agreements, how the transaction will bring the project into compliance.
- If in default:
  - A discussion on specific problems, events and trends that caused the default.
  - An explanation of where funds will be obtained to bring the loan current.

_____ Certification from the lender that they will obtain GNMA approval for prepayment of the security holders, prior to implementation of any interest rate reduction.

_____ Debt Service Coverage Ratio (DSCR) analysis at the estimated interest rate for the revised loan.

_____ Most recent Interim and Year-end Financial statement.

_____ Draft Mortgage Documents prepared by counsel.

_____ PCNA (Required if the loan has been in default during the last 24 months, or if the current PCNA is older than 10 years. Servicers should discuss PCNA's aged 5-10 with HUD prior to submission to mitigate any issues.)

_____ Prepaid envelope for returning executed documents.

Field Analysis

Y/N

_____ Verification owner is in compliance (or will be) with all business agreements.

_____ Review completed of MOR and REAC reports for any outstanding issues.

_____ Review Draft Sources and Uses.

_____ Verification of no unauthorized distributions.

_____ If required, PCNA reflects Reserve for Replacement account is adequately funded and that annual contributions are sufficient for future needs.

_____ E-mail or memorandum from local OGC counsel on acceptability of mortgage documents with respect to the interest rate reduction.

Date Lockout Expired from GNMA database: ___________.

Projected DSCR: ________**(Must exceed 1.05)**

Date memorandum to Hub Director recommending approval: ___________

Prepared By:_________________________ Date:____________

Reviewed By:________________________ Date:____________

PC Director:_________________________ Date:____________

Hub Director:________________________ Date:____________*

*The Hub Director's signature is required for all request for Interest Rate Reductions sent to Headquarters for approval.