HUD-insured financing of MF projects: What is the status today?

The Federal Housing Administration, a division of the Department of Housing and Urban Development, provides mortgage loan insurance for the purchase, refinance, construction and substantial rehabilitation of apartments, assisted-living facilities and skilled-care nursing homes. The benefits of HUD-insured loans include: the low interest rates HUD-approved mortgage lenders are able to offer; long amortization periods at fixed interest rates (35 years for acquisition/refinance and 40 years for new construction); loans are fully assumable; loans are nonrecourse; and there is a seamless conversion from construction loan to permanent loan.

A major drawback of HUD financing always has been the time required to prepare and process the loan insurance application. In the case of new construction and substantial rehabilitation projects, the process includes lengthy periods of time for: the borrower's pre-application submission; HUD's pre-application review and invitation to the borrower to submit an application; the borrower's preparation of an application submission package; and HUD's issuance of a firm commitment to insure the loan.

Renewed interest in the apartment asset class and historically low interest rates for the Government National Mortgage Association securities issued to fund HUD-insured loans created a substantial processing backlog in recent years. During the past few years, projects have been waiting in the HUD Region 8 Lender's Queue (the waiting list for projects requesting firm commitments located in Colorado, Montana, North Dakota, South Dakota, Utah and Wyoming) for up to six months before being reviewed by HUD.

■ **Good news: the queue is getting shorter.** In recent months, the processing times have shortened, thanks to relief from other, less-busy HUD offices taking on some of Region 8's applications and fewer HUD-insured loan applications due to the return of traditional capital sources to the market.

Steve Wessler, senior vice president and national director of Red Stone Agency Lending, has had years of experience with HUD-insured loans. According to Wessler, "Just over a year ago, the Region 8 office had as many as 20 or more applications 'waiting to be processed.' These applications would remain in the queue for six months before they were even being looked at. Now it is generally inside of 30 days from the day HUD receives the application to the date HUD's review begins."

■ **New underwriting standards for large loans.** Due to the dramatic increase in recent years,

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in the number and size of loans insured by HUD, the department has issued new underwriting standards to decrease its risk exposure. HUD is particularly concerned about its exposure to loans above $25 million and projects above 150 units. HUD has determined that these loans pose a greater risk to the FHA insurance fund due to the potential impact of the failure of even one large loan.

At the end of last year, HUD issued new underwriting standards for loans above $25 million and/or loans that support projects with greater than 150 units. Mortgagee Letter 2011-40 regarding "Large Loan Risk Mitigation Policies" provides details of the new standards (the "2011-40 Standards"). See U.S. Department of Housing and Urban Development, Mortgagee Letter 2011-40, Large Loan Risk Mitigation Policies (Dec. 29, 2011).

In general, the 2011-40 Standards increased the debt-service coverage ratio and initial operating deficit requirements, and decreased the loan-to-cost ratio. For new construction or substantial rehabilitation loans, the 2011-40 Standards prohibit the release of cash-out proceeds for excess value of contributed property until the completed project has operated at breakeven occupancy for at least 12 consecutive months. For loans applying for refinancing under Section 223(f) (under the three-year rule waiver for projects less than three years removed from certificate of occupancy), the 2011-40 Standards increased the debt service reserve requirement for loans greater than $25 million or 150 units from four months to six months of debt-service coverage. Loans greater than $40 million or 251 units must have nine months of debt-service coverage.

For loans greater than $25 million under any rental insurance program, there are now strict requirements for the project's principals' liquidity and net worth. The mortgagor's principals (with possible waiver for sponsors of affordable projects) must have, in aggregate, net worth of at least 20 percent of the loan amount and liquidity equal to at least 7.5 percent of the loan amount. Additionally, large-loan borrowers must have substantial prior experience developing, constructing and owning multifamily projects that are similar in size and scope to the proposed project.

HUD also has limited the borrower's ability to recognize land or building value appreciation. For properties held for less than three years, HUD will not recognize an increase in the appraised value above the borrower's acquisition cost plus the direct costs incurred for property improvements unless the borrower can demonstrate that the value increase is based upon an increase in net operating income due to improved operations, and not based solely on a lower cap rate than what was prevalent in the market at the time of acquisition, or that the value of comparables has also increased since the acquisition date.

Despite these strict requirements, and the return of other funding sources, HUD still plays a significant role in financing multifamily projects. Given these recent changes, it is imperative to involve a qualified underwriter and counsel in your early planning stages, as these new standards change transaction economics significantly.