ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

February 3, 2012

MORTGAGE LETTER 2012-1

TO: **All FHA-Approved Multifamily Mortgagees**

SUBJECT: **Multifamily Low Income Housing Tax Credit Pilot Program**

I. Purpose

This Mortgagee Letter (ML) launches a pilot program (the Tax Credit Pilot or Pilot), mandated by the Housing and Economic Recovery Act of 2008, Public Law 110-289, in subtitle B of Title VIII, cited as the Housing Tax Credit Coordination Act of 2008 (HERA), to streamline FHA mortgage insurance applications for projects with equity from the Low Income Housing Tax Credit (LIHTC) program. The Tax Credit Pilot creates a distinct application platform and a separate processing track under the Section 223(f) program. This ML describes the features of the Tax Credit Pilot, including underwriting criteria, eligibility requirements, application exhibits and the process for HUD application review. This ML also extends the 3-year rule waiver (ML 2011-13) for 1 year beyond its current February 2012 expiration date for tax credit projects that participate in the Pilot program, as more fully detailed in Section IV, A(1)(a), below.

II. Background

This ML launches the first phase of the Tax Credit Pilot by providing permanent financing on transactions that are low risk so as to allow FHA to significantly streamline the review process and create efficiencies without increasing risk. The first phase of the Pilot will permit applications for permanent financing processed under Section 223(f) for properties that are recently constructed and occupied, for preservation and moderate rehabilitation of properties with Section 8 rental assistance or for older, stabilized tax credit properties through the syndication of new credits.

The Tax Credit Pilot is designed to expedite application processing to meet the tight external deadlines imposed by the LIHTC program. These expedited processing timeframes are necessary since the failure to meet bond closing or other LIHTC performance deadlines may result in the forfeit of the credit allocation or bond reservation and may jeopardize the borrower's ability to secure LIHTCs for future transactions. The sequential application processing systems detailed in the MAP Guide did not anticipate the timing requirements of the LIHTC program. As a result, it is often difficult or impossible for HUD, the lender and the borrower to meet the tax credit time frames using MAP. The Pilot will only permit MAP lenders and HUD offices with proven tax credit lending expertise to process applications.

III. Programs Available under the Pilot

Phase one of the Pilot will consist of three types of transactions:

- Section 223(f) acquisition and/or refinance and moderate rehabilitation of properties with at least 90% of the units supported by a project based rental assistance contract, and with rehabilitation performed at levels that are higher than has previously been permitted by the program, but with tenants remaining in place in their units except for temporary relocation during the rehabilitation. Projects with other forms of rental assistance (including rent supp, RAP or project based vouchers) do not qualify.Section 223(f) permanent financing of newly constructed or substantially rehabilitated projects that are complete, have reached stabilized occupancy and are processed under an extension of the 3-year rule waiver that is currently in effect.

- Section 223(f) permanent financing and moderate rehabilitation of stabilized tax credit projects that are being re-syndicated with new credits and new equity investors, with rehabilitation performed at levels that are higher than has previously been permitted by the program but with tenants remaining in place in their units except for temporary relocation during the rehabilitation.

The purpose of the standing waiver of the 3-year rule is to permit developers to substitute a FHA permanent loan for an existing high rate forward commitment. Given the Section 223(f) program's low rates, higher lending ratios and 35 year amortization, there should be sufficient excess loan proceeds to pay forward rate lock breakage penalties, and thereby give the project a better permanent debt alternative. The 3-year rule transactions are low-risk to FHA because the insured loan is used as the "take out" source after the project has achieved full, stable occupancy, thereby avoiding construction and lease-up risk to the Department.

Moderate rehabilitation of LIHTC and rental assistance properties is defined as repair work that exceeds the limits permitted by the Section 223(f) program, up to but not to exceed $40,000 per unit in hard costs (with no adjustment for high cost areas). The Tax Credit Pilot will permit the permanent financing and moderate rehabilitation of rental assistance properties or stabilized tax credit projects that are being re-syndicated with new credits and new equity investors, with rehabilitation performed with tenants remaining in place and at levels that are higher than what had previously been permitted. These projects pose little risk to the Department because either the project income is expected to continue under the Section 8 rental assistance contract or the existing tax credit project will have been in operation on a stabilized basis for many years before funding (in the case of re-syndicated projects).

The Section 223(f) financing being made available under the Pilot can be used with taxable financing or with tax exempt bonds.

The Pilot creates a distinct application submission format and involves streamlined application processing, but it does not alter underwriting standards or other program requirements under the MAP Guide. Tax credit applications submitted under programs that are not eligible for the Pilot or in offices where the Pilot is not yet offered, will continue to be processed under standard MAP procedures.

HUD will issue guidance subsequent to this ML detailing the process for lenders to submit qualifications to participate in the Tax Credit Pilot. Lenders will have a period of 30 calendar days from the date of that guidance to apply for participation. Lender qualifications (as discussed in Section V.A., below) will be submitted to the Multifamily Office of Development in HUD Headquarters. The Office of Development will review the submissions, and within 30 calendar days of the close of the lender submission period, will announce the lenders and the Multifamily Hubs selected to participate. Once lenders are selected, these lenders may submit new eligible Pilot applications to the participating Hubs at any time, on a rolling basis. Lenders will also have a period of 45 calendar days following the notification of selection for the Pilot to transfer applications for mortgage insurance that involve LIHTC and have already been submitted for MAP processing to processing under the Tax Credit Pilot. To be considered for a transfer from MAP to the Tax Credit Pilot, the project must meet the eligibility requirements for the Pilot, and the application may not be in an advanced stage of Firm Commitment processing. The Hub Director has the sole authority to consider and approve or reject lender requests to transfer applications from MAP to Pilot processing. Such transfers must occur during the 45 calendar day period after the lender notification of Pilot participation. HUD will not consider transfer requests made after this period.

IV. Pilot Eligibility

Transactions that meet these requirements may be processed under the Tax Credit Pilot:

A. Eligible programs and projects. The Pilot involves only those Section 223(f) transactions that meet the following criteria:

   1. Section 223(f) acquisition or refinance with rehabilitation. The project must meet at least one of the following criteria:

      a. 3-Year Rule waiver. The property must meet the criteria detailed in Mortgagee Letter 2011-13 for the consideration of a waiver of the “3-year rule” to apply for FHA mortgage insurance within 3 years of initial occupancy on construction projects that did not pay Davis Bacon wage rates. The requirements of ML 2011-13 will apply, except that applicants for a 3-year rule waiver need not demonstrate that they have sought and been unable to obtain alternative permanent financing.

      b. Housing with Rental Assistance. To qualify, the property must have a Section 8 project-based rental assistance contract which covers 90% or more of the units. The borrower must execute a renewal Section 8 HAP contract with a 20-year term with or in advance of the refinance transaction, with contract funding subject to annual appropriations. If the project is in the midst of a multi-year term, the Owner and HUD must, by mutual agreement, terminate the existing HAP contract and execute a Renewal Contract with a 20 year term, subject to the availability of appropriations. The Owner must also agree to execute an Exhibit to the Section 8 HAP contract agreeing to renew the HAP contract at the end of the 20-year term for the minimum of the number of years remaining on the contract in place at the time of the early termination and must execute the Preservation Exhibit.

As part of the contract renewal, the borrower must request of Asset Management any desired rent increase, whether budget-based or market-based, prior to the submission of the application for processing under the Pilot. As described below, the MAP lender must work with the borrower to address the rent request as part of the loan underwriting prior to submission. Lenders are advised that, if the borrower is requesting a market-based rent increase at "post rehab" market rent levels to support the new insured loan at initial closing, then a Section 8 escrow will be required to fund the difference between the existing rents and the post-rehabilitation rents during the construction period. Lenders should include this escrow in their underwriting. Borrowers should refer to the Section 8 Renewal Policy Guide for details on post-rehab rents.

c. Re-syndicated LIHTC Projects. Moderate rehabilitation with Section 223(f) permanent financing will be available for stabilized tax credit projects being re-syndicated using new credits with new equity investors and with rehabilitation with tenants in place. Projects must have stable occupancy with a history of 85% or greater occupancy for the previous 12 months. For re-syndicated tax credit projects without rental assistance, a funded reserve equal to 6 months of debt service (with a credit for funded debt service reserves at the partnership level) is required. Underwritten project Effective Gross Income (EGI) cannot exceed 105% of historical EGI, and the post-rehab underwritten operating expenses cannot be less than 90% of the historical operating expenses, with adjustments permitted for repairs and maintenance, capital expenditures and energy improvements.

d. Repairs and relocation. An application may propose a moderate level of repairs, defined as up to $40,000 per unit in hard costs, which may not be regionally adjusted. For moderate rehabilitation projects, the Pilot will require many of the controls of the Section 221(d)(4) substantial rehabilitation program, including the requirement for the borrower to contract with a licensed architect to perform the project needs assessment, to scope and oversee the repair work, and to complete plans and specifications, if necessary. If advised by the project architect, this repair work must be performed by a General Contractor. The repair work will be subject to monthly inspections and lender control over draws. The completion assurance escrow required by the Section 223(f) program will serve as a construction contingency (with a credit given for a funded repair contingency held at the partnership level). Payment of Davis Bacon wage rates is not required if the additional rehabilitation expenses that are above the dollar amount of repairs allowed under the standard Section 223(f) program are paid from tax credit equity and not from mortgage proceeds. For projects with repairs at or below the limits permitted by the standard Section 223(f) program, the lender will follow existing program escrow and draw procedures.

The proposed repair work may exceed the 12-month time limit for completion of non-critical repairs typically required by the Section 223(f) program. However, the scope of work may not rise to the level of repairs that would require relocation of project residents beyond temporary relocation and as may be required to make unit improvements. To be eligible, temporary relocation of tenants out of their units generally should be for no more than a few days and may not exceed 2 weeks. The application must include a detailed management plan addressing on site staffing, a work and relocation schedule, and a plan and budget for relocation of residents with funds for relocation escrowed. If more extensive relocation or greater repairs are necessary, the MAP lender must underwrite the project as a Section 221(d)(4) substantial rehabilitation transaction, and it will not be eligible for the Pilot. Properties with rental assistance may require compliance with the Uniform Relocation Act (URA); lenders should work with the Hub office to determine if URA applies.

B. Eligible Projects and Loan Amounts. The project may have either 4% LIHTC with tax exempt bonds or 9% LIHTCs, with evidence of the LIHTC or bond allocation or reservation and an equity investment commitment submitted with the application. Projects must have a third-party equity investor and may not be funded solely through the exchange or TCAP programs. Projects may have 10% or less commercial effective gross income or net rentable space. The maximum loan amount available under the Pilot is $25 million.

C. LIHTC rents. For projects participating in the Pilot, 90% or more of the units must have low income occupancy and rent restrictions and must use tax credits. Except for properties with rental assistance, projects must demonstrate that the tax credit rents are at least 10% below comparable unrestricted market rents for all unit types. For properties with 90% or more of the units with rental assistance, the transaction must be underwritten using approved project-based HAP contract rents.

V. Application Processing

A. Approval of MAP lender. Lenders must be pre-qualified to participate in the Pilot. Subsequent to this ML, HUD will issue guidance to open a 30-day period during which MAP lenders may submit requests to HUD HQ Office of Development for Pilot participation. The lender submission must detail the following experience:

1. Experience in the underwriting and processing of FHA MAP loans for LIHTC and/or bond transactions, particularly during Fiscal Years 2009, 2010, or 2011, including the names and dates of these transactions and the current status and performance of the insured loans.

2. Experience underwriting LIHTC transactions using GSE or other State or Federal loan

programs, if in addition to the requisite FHA MAP experience.

3. Experience underwriting loans to projects receiving Section 8 project-based rental assistance (if the lender intends to underwrite assisted property transactions under the Pilot).

4. Experience underwriting Section 223(f) loans that required a waiver of the 3-Year Rule.

5. Experience processing tax credit loans using MAP in the Hubs where the Pilot will be offered.

B. Designated Multifamily Hubs. HUD HQ will determine which Hubs will participate in the first phase of the Pilot based on the office's experience with tax credit lending and its capacity to execute Pilot transactions as described in this ML without detracting from the processing of its regular application pipeline. Participating Hubs will be announced by the publication date of this ML.

C. Designated Underwriter. Each participating Hub must designate one staff person to serve as a Designated Underwriter (DU) for the Pilot. This individual must be a supervisor, for example a MAP Team Leader/Supervisory Project Manager, and must be experienced in the underwriting and/or review of LIHTC transactions. The Hub Director will also designate an alternate supervisor to serve as the back-up in case the DU is unavailable.

D. Designated Asset Management Point of Contact (POC). HQ Office of Asset Management will designate one member of the HQ Asset Management staff to serve as the POC for all Tax Credit Pilot applications. This individual will have expertise in coordinating the various HQ and field staff Asset Management approvals that may be required for a Section 223(f) acquisition or refinance of an assisted project, including: assisting with approval of a renewal HAP contract and Section 8 rent increase, approval for prepayment of an existing FHA insured loan and special approvals such as Interest Reduction Payment (IRP) Decoupling, Flexible Subsidy Loan deferral, certain 2530 approvals, and/or other related waivers or approvals.

E. Required concept meeting. Prior to submission of an application under the Pilot, the lender must participate in a concept meeting with the DU and other Hub staff as the DU deems appropriate, to discuss the transaction, the proposed repairs and any necessary Asset Management approvals. Participation in a concept meeting does not necessarily mean that an application will be approved for submission under the Pilot and it may be determined that a proposed Pilot application is more appropriate for standard MAP processing due to the complexity of the issues or the risks presented by the transaction. At the concept meeting, it must be shown that the project meets all of the eligibility criteria for participation in the Pilot (listed in Section IV, above).

F. Application submission. The application, including the required narrative, third-party reports and HUD forms will be submitted to the DU in electronic format, with a single original paper copy. The required forms documents must be submitted in "fillable" form (no PDFs) so that HUD staff and the lender may make amendments electronically as needed.

G. Application completeness. The application, including the lender's Underwriting Narrative and exhibits, must be complete at submission. If the DU and Hub Director determine that program thresholds are not met or if required exhibits are missing, the application will be rejected within 5 business days of receipt. HUD will not issue Deficiency Letters under the Tax Credit Pilot. The Hub Director will determine if the lender will have the option to re-submit applications rejected under the Pilot for standard MAP processing.

H. Firm Commitment processing. All Pilot applications will be one stage, Direct-to-Firm applications. The Tax Credit Pilot streamlines a number of application exhibits in order to focus on risk mitigation and minimize the number of reviews. The DU will review the 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 DU will not delegate portions of the application review to HUD technical staff except in rare cases when such review will assist with mitigating risk, with resolving complex transaction issues and/or with compliance with regulatory requirements. The DU will conduct the review in accordance with the following guidelines:

1. Narrative and sources and uses review. The DU will review the lender's Underwriting Narrative, application exhibits and forms. The DU 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 DU 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 DU believes may be in excess of the permitted rehabilitation limits under the Pilot, or b) where relocation of project residents is beyond the 2 week limit permitted. The DU will engage the HUD Architect to review Fair Housing Act compliance and other accessibility issues, as necessary. The DU will review the lender's mortgage credit analysis.

3. Appraisal/Valuation review of assisted housing transactions (with 90% or more of the units covered by a rental assistance contract) will involve the following steps:

    a. The borrower must have a new or renewal 20 year Section 8 HAP Contract in place (executed no later than 1 year prior to the Tax Credit Pilot application), or must request a 20 year Section 8 HAP contract renewal in conjunction with the Section 223(f) refinance/acquisition. If the borrower is requesting a HAP contract rent increase, the Contract Renewal Request Form (Form HUD-9624) and supporting documentation must be submitted by the borrower to the Performance Based Contract Administrator (PBCA) prior to submission of the

Tax Credit Pilot application. The rents and expenses submitted to the PBCA must match the underwriting in the lender's Tax Credit Pilot application. If the borrower is requesting a budget-based rent increase, the request to the PBCA must include the debt service figure from the lender's underwriting for the Pilot application. Should the debt service figure or any other line item in the income and expenses change due to the processing of the Pilot loan application, the borrower must provide the final debt service figure and other final figures to the PBCA once the Firm Commitment is issued. The PBCA will include the final debt service figure in the approved rents prior to closing of the Section 223(f) loan.

b. If a HAP Contract rent increase is requested and a Rent Comparability Study (RCS) is required, the lender must submit the RCS and Form HUD-92264 as required exhibits of the Tax Credit Pilot mortgage insurance application.

c. The Underwriting Narrative must explain how the RCS income and expense conclusions compare to the Net Operating Income estimate used by the lender in the underwriting. The lender is strongly encouraged to underwrite the loan using the income and expenses requested by the borrower on Form HUD-92264. Failure to do so will result in rejection of the application, unless the Underwriting Narrative makes a compelling justification for the difference. If the Underwriting Narrative does not adequately justify the difference between underwritten rents and rents requested on Form HUD-92264, the application will be rejected.

d. A MAP-compliant third-party appraisal is required. 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 DU will perform a desk review of the appraisal and the lender's appraisal analysis and, except as provided in e, below, this review will not be assigned to the HUD appraiser. The DU review of the third-party appraisal will address the appropriateness of the income and expense figures used in the project underwriting, as compared to the RCS and the operating expense information in iREMS.

e. The DU may request the HUD appraiser to review the third-party appraisal, the RCS, and the lender's appraisal analysis in certain limited cases to provide the following:

    i. Analysis of the discrepancy between the income and expense conclusions in the third party appraisal or the lender's underwriting and the RCS submitted with the HAP contract rent increase request.

    ii. Analysis of any significant reduction in operating expenses. If the application assumes that project operating expenses will drop 10% or more from historical expense levels, the DU may request a desk review by a HUD appraiser. If the reduction in project operating expenses stems from assumed reductions in repairs and maintenance, capital expenditures and energy costs, the lender must detail these assumptions in the Underwriting Narrative.

4. Project site visit. The DU 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.

5. Environmental Review. The environmental review will be conducted by a trained HUD environmental reviewer (typically a HUD appraiser) per the requirements of Chapter 9 of the MAP Guide. The Phase I ESA must contain no significant unresolved environmental issues that would require a Phase II ESA or a Remediation Plan. A separate site visit by the environmental reviewer will not be required if both of the following conditions are met: a) the Phase I ESA as augmented by the vapor encroachment screen demonstrates that the property does not have Recognized Environmental Conditions or Vapor Encroachment Conditions (RECs/VECs) and the HUD environmental reviewer concurs with this determination; and b) the environmental issues listed in the Sample Field Notes Checklist (SFNC) required by Section 9.5 of the Guide conforms to the Guide requirements and the HUD environmental reviewer does not identify any issues or concerns that require field investigation.

6. Role of HUD HQ. Staff in the HQ Office of Multifamily Development will track and monitor projects being processed under the Tax Credit Pilot and will provide guidance to DUs in participating offices to resolve issues and help manage the pipeline. The role of the HQ staff will be as follows:

   a. Hold bi-weekly tracking calls with participating Hubs;

   b. Provide guidance to DUs on specific transactions; and

   c. Provide training to participating HUD and lender staff on Pilot program, policy and process issues.

7. Issuance of Firm Commitment. At completion of application processing, the DU will present a brief Underwriting Memorandum with a Firm Commitment recommendation to the Hub Director. Pilot transactions will be reviewed by the Hub loan committee before the Firm Commitment is issued.

8. Closing. The closing of Tax Credit Pilot transactions will follow the Section 223(f) loan closing process described in the MAP Guide, with the following exceptions:

a. Waiver of ALTA Survey. The DU may recommend a waiver of the ALTA Survey for 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.

b. Deferred submission of plans and specifications. Tax Credit Pilot transactions under Section 223(f) may follow the process for deferred plans and specifications which may be submitted prior to closing.

c. Submission of Tax Credit Limited Partnership Agreement. The Limited Partnership Agreement is to be submitted for review with the application for Firm Commitment, if available.

d. The DU may opt to review any or all of the closing documents, or may delegate this review to HUD project management or underwriting staff.

e. 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.

9. Timing. The goal of the Tax Credit Pilot is to issue the Firm Commitment within 60- 90 calendar days of submission of a complete application, and to close the loan within 90 – 120 calendar days of submission.

VI. Implementation

This Mortgagee Letter is effective immediately.

If there are any questions regarding this ML, please contact Margaret S. Salazar, Senior Housing Program Specialist 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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