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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

April 26, 2012 **MORTGAGEE LETTER 2012-8**

TO: All FHA-Approved Multifamily and Healthcare Mortgagees

SUBJECT: Policy Regarding Interest Rate Swap Termination Fees Associated with Debt to be Refinanced in Connection with Healthcare and Multifamily Mortgage Insurance Applications

Purpose

This Mortgagee Letter sets forth the Department's policy in defining the indebtedness eligible for refinancing in connection with healthcare (Sections 232 and 242) projects and in connection with multifamily projects to include, under certain circumstances, interest rate swap termination fees. It applies to debt to be refinanced in connection with Section 223(f), substantial rehabilitation, or replacement facility projects. This Mortgagee Letter will benefit prospective mortgagors who meet all of the qualifications of the healthcare and multifamily mortgage insurance program(s) under which they apply, and who may wish to refinance interest rate swap agreements they entered into before January 1, 2009, which were integrated into the original financing.

Background

For many years, a widely used financing practice for healthcare and multifamily facilities was to use variable rate, short-term bonds coupled with an interest rate swap that converted the facility's variable payment to a fixed payment. This practice provided borrowers with rates lower than conventional long-term bonds and insulated them from interest rate variability. The risks were assessed as low at the time; in fact, some lenders required bonds to have integrated interest rate swap agreements as part of the original financing.

In the credit crisis of 2008, the variable rate/auction rate markets lost liquidity; also, credit enhancers (bond insurers and banks that issued letters of credit) were downgraded. As a result, under applicable bond covenants, many borrowers were forced to pay interest based on very high rates because of their failure to maintain the high credit ratings required by the covenants. To avoid these rates, the borrowers have sought to refinance the original debt, which requires them to terminate the interest rate swap contracts that are integrated into the original bond financing. Under the terms of the interest rate swap contracts, borrowers must often pay fees to terminate those contracts.

The Department favors allowing mortgage proceeds to be used for swap termination fees, within certain limits as described below, to allow a facility meeting FHA underwriting standards to obtain low-interest, fixed-rate financing. Doing so is consistent with the public purpose of the Department's healthcare and multifamily housing programs and is consistent with the long-established practice of using mortgage proceeds for prepayment premiums or penalties in conjunction with a refinancing; these prepayment costs are the functional equivalent of swap termination costs.

Discussion of Loan-to-Value

In the Conditions below, there are loan-to-value requirements that are lower than maximum loan-to-value ratios permitted by Healthcare and Multifamily statutes. This ML cannot and does not change those limits. However, inclusion of swap termination costs in the mortgage introduces additional insurance risk that could not have been foreseen at the time the statutes were enacted. There is additional risk because the cost of terminating a swap contract is not tied to an asset securing the mortgage loan. For this reason, prudent underwriting suggests that a lower loan-to-value should be a requirement for insuring a loan that includes swap termination cost. If the applicant chooses to terminate the swap contract using funds other than insured loan proceeds, then the proposal may request insurance of a loan up to the statutory maximum, and HUD will consider that request. However, if the applicant chooses to include the swap termination cost in the insured loan, then HUD shall impose a loan-to-value requirement with an upper limit that is lower than the statutory maximum.

Conditions for Allowing Use of Mortgage Proceeds for Swap Termination Costs

1. For interest rate swap contracts related to tax-exempt financing, the termination cost must be for an interest rate swap that was entered into as an interest rate hedge at the same time as the original financing. In determining if a swap is eligible for inclusion of its termination cost in the FHA-insured mortgage loan, lenders may refer to the discussion of a "Qualified Hedge" under Section 1.148-4(h) of the Treasury Department regulations. The terms of the swap must be acceptable to HUD for its termination cost to be considered for payment with borrowed funds. At HUD's request, the application for mortgage insurance must include a legal opinion from a qualified counsel that the swap meets the definition of a "Qualified Hedge" or is substantially in conformance with that definition.

2. For interest rate swap contracts related to taxable financing, the termination cost must be for an interest rate swap that was integrated with the original financing and entered into as an interest rate hedge within 15 days of the original financing.

3. HUD will determine as a first step in its review of a proposal if the cash position of the healthcare facility or system appears sufficient to allow available cash to be used to pay all or some of the swap termination cost.

4. Standard FHA underwriting applies to all programs, as modified herein.

5. Loan-to-Value:

   a. In calculating loan-to-value (LTV), the eligible costs for the use of mortgage loan proceeds will include the swap termination cost, within the limits of this paragraph.
   b. For a Section 232 mortgage that includes swap termination costs, the LTV shall not exceed 80% (vs. 85% permitted by statute).
   c. For a Section 242 mortgage that includes swap termination costs, the LTV shall not exceed 85% (vs. 90% permitted by statute).
   d. For Section 223(f) multifamily mortgages that include swap termination costs, the LTV shall not exceed 80%, or as otherwise specified in guidance for "large loans."

6. Limits on Swap Termination Costs as a Percent of Mortgage Proceeds

   a. No more than 10% of the insured mortgage proceeds may be used for swap termination costs in Section 223(f) refinancing transactions.
   b. No more than 5% of the insured mortgage proceeds (not to exceed $10 million) may be used for swap termination costs for refinancing in connection with substantial rehabilitation or replacement facility projects.

7. This policy is meant to address the significant disruption within the variable rate financing market during late 2008. Therefore, this policy applies only to interest rate swap contracts in place prior to 1/1/09.

8. The mortgagor has no further or residual financial obligations after termination of the interest rate swap.

9. If there is more than one swap contract, the contracts shall be netted against one another, in case the facility realized a positive return on one but owed a termination fee on another.

10. HUD will require a "Fairness Certification" from the broker/dealer or interest rate swap provider that:

a. Calculation of fees is correct and fair pursuant to the original interest rate swap contract;
b. No other consideration is involved; for example, a higher termination fee is not being charged in connection with additional services to be provided to the healthcare facility or system; and
c. For interest rate swap contracts related to taxable financing, the termination cost is for an interest rate swap contract that was integrated with the original financing and entered into as an interest rate hedge within 15 days of the original financing.

11. HUD will review and approve the sources and uses of mortgage proceeds related to payment of the interest rate swap termination fee/penalty.

Implementation

This Mortgagee Letter is effective immediately.

If there are any questions regarding this Mortgagee Letter, please contact:

- For Healthcare: John Whitehead, Policy Advisor, Office of Healthcare Programs, at (202) 402-5790.

- For Multifamily: Daniel Sullivan, Acting Director, Office of Multifamily Development, at (202) 402-6130.

Persons with hearing or speech impairments may access this number via TDD/TTY by calling 1-877-TDD-2HUD (1-877-833-2483).

Carole J. Galante
Assistant Secretary for Housing-
Federal Housing Commissioner