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

OFFICE OF THE ASSISTANT SECRETARY
FOR HOUSING-FEDERAL HOUSING COMMISSIONER

September 15, 2010

MORTGAGEE LETTER 2010-32

TO: ALL FHA APPROVED MULTIFAMILY MORTGAGEES

SUBJECT: Revision to Policy for Partial Payment of Claims and Mortgage Modifications

A. Purpose

A revision is in process to HUD Handbook 4350.1, Chapter 14. This Mortgagee Letter addresses and immediately implements several policy changes to Partial Payments of Claim (PPC) and Mortgage Modifications.

This Mortgagee Letter complements Mortgagee Letter 87-9 which allows for the waiver of prepayment penalties and lockout provisions in mortgages to avoid a mortgage insurance claim. Properties approved for a PPC or mortgage modification are deemed to have complied with all terms of Mortgagee letter 87-9.

Specific Policy Changes from the current version of 4350.1, Chapter 14 are:

1. For all PPC's and mortgage modifications, a Use Agreement will be required.
2. Recast first mortgage notes will be underwritten at a market interest rate at the time of approval.
3. A Project Comprehensive Needs Assessment (PCNA) may be required.
4. HUD will no longer limit the size of a PPC claim payment to three times the owner's contribution.
5. Mortgage modifications that are requesting overrides of a lock-out or prepayment penalty allowed under Mortgagee Letter 87-9 must follow the procedures of Chapter 14.

Specific terms related to the above policy changes are detailed under C- H below.

B. Background

The regulations for a Partial Payment claim are found at 24 CFR 207.258b. When the FHA Commissioner receives notice under 24 CFR 207.258 of a mortgagee's intention to file an insurance claim and to assign the mortgage to the Commissioner, the Commissioner may request the mortgagee, in lieu of assignment, to accept a partial payment of the claim under the mortgage insurance contract and to recast the mortgage, under such terms and conditions as the Commissioner may determine.

The Commissioner may request the mortgagee to participate in a partial payment of claim in lieu of assignment only after a determination that partial payment would be less costly to the Federal government than other reasonable alternatives for maintaining the low- and moderate-income character of the project. This determination shall be based upon the findings listed below and such other findings as the Commissioner deems appropriate:

1. The mortgagee is entitled, after a default under 24 CFR 207.255, to assign the mortgage in exchange for the payment of insurance benefits;
2. The relief resulting from partial payment, when considered with other resources available to the project, would be sufficient to restore the financial viability of the project;
3. The project is or can (at reasonable cost) be made physically sound;
4. The management of the project is satisfactory, as shown by a rating of at least satisfactory on the most recent management review;
5. The default under the insured mortgage was beyond the control of the owner;
6. The project is, or potentially could serve as a low- and moderate-income housing resource;
7. The property covered by the mortgage is free and clear of all liens other than the insured first mortgage and other liens approved by the Federal Housing Administration (FHA) Commissioner;
8. The mortgagee has voluntarily agreed to accept a PPC under the mortgage insurance contract and to recast the remaining mortgage amount under terms and conditions prescribed by the FHA Commissioner, and
9. The owner has agreed to repay to the FHA Commissioner an amount equal to the partial payment, with the obligation secured by a second mortgage on the project containing terms and conditions prescribed by the FHA Commissioner. The terms of the second mortgage will be determined on a case-by-case basis to ensure that the estimated project income will be sufficient to cover estimated operating expenses and debt service on the recast insured mortgage.

Pursuant to the terms of Mortgagee Letter 87-9, overrides of a lockout or prepayment penalty provision in the mortgage documents which may be requested only if the mortgage is in default. This may have the unintended effect of discouraging the owners from carrying the project while they attempt to resolve problems that were caused through no fault of the owner. The extensive proposal requirements and review by HUD mitigate any concern that the mortgage modification could be contrived solely to lower the interest rate.

C. <u>Use Agreement</u>

1. The Use Agreement will have a term of 20 years from the date of the PPC or mortgage modification.
2. All debt, including the recast first mortgage on the property will be subordinated to the Use Agreement.

3. If the property is already covered under a Land Use Restriction Agreement (LURA), the HUD Use Agreement may mirror the set aside requirements under the LURA.
4. For all other properties, a set aside of at least 30% of the units for residents with incomes at or below 80% of Adjusted Median Income (AMI) at rents not to exceed 30% of 80% of AMI will be the initial basis for analysis. Owners may request a lower percentage of units (not less than 10%) and/or higher percentage of AMI than 80%, but they must justify the requested modification through comparative modeling, market studies reflecting demand for affordable housing, current tenancy and property support through owner contributions.

D. Recast 1st Mortgage Note Rate

1. HUD will underwrite the recast first mortgage at 125 basis points over the 10 year Treasury rate on the day a terms letter is offered to the owner.
2. The Debt Service Coverage ratio, including Mortgage Insurance Premium will be a minimum of 1.20.
3. If rates have increased since the day the owner submitted a request for a PPC, the rate on the day a complete PPC package was submitted to HUD will be used for determining compliance with the retained policy of a maximum PPC of 50% of the current outstanding principal balance.
4. If the mortgagee is able to place the loan at a lower rate at closing than the underwritten rate, HUD will not adjust the recast mortgage amount.
5. If a mortgagee cannot place the loan at or below the rate approved by HUD, mortgagees may provide HUD a certification that they have fully disclosed the terms of the recast mortgage for placement in a REMIC. If the mortgagee provides a certification, the rate may be increased up to an additional 50 basis points (with a corresponding reduction in the recast mortgage) without further HUD approval.

E. Project Comprehensive Needs Assessment (PCNA)

A Project Comprehensive Needs Assessment (PCNA) may be required:

1. For all PPC or Mortgage Modification applications when the initial endorsement is greater than 10 years from submission.
2. When reserves are less than $250/unit.
3. If required by the Hub Director when the Real Estate Assessment Center (REAC) physical inspection score is below 80 points.

F. Owner Contribution

HUD will no longer limit the size of a PPC claim payment to three times the owner's contribution.

The PPC policy requiring an owner's contribution of at least 5% of the original loan amount remains. Mortgage modifications will require the same level of support.

G. Second Mortgage – PPC Note

Subject to any requirements for additional owner cash or excess project cash, HUD will include in the PPC Note amount interest computed since the date of delinquency based on the actual number of days in a 365 or 366 day year. Late fees accrued since the last payment or any other costs to close cannot be included in the transaction or paid by the project in the future.

The terms of the second mortgage will be as follows:

1. An interest rate equal to the Applicable Federal Rate for the month of closing.
2. Maturity date co-terminus with the first mortgage.
3. A “due-on-sale, refinance, or termination” provision.
4. As long as the Note is held by HUD, a service charge calculated at 0.5 percent annually, based on the unpaid principal balance of the HUD-held Second Mortgage, must be paid to HUD monthly.
5. The minimum annual payment on the HUD-Held Second Mortgage will be 75 percent of annual surplus cash as specified in the Regulatory Agreement between the Secretary of Housing and Urban Development and the project owner together with the applicable HUD Regulations and administrative requirements. The surplus cash payment is due within 10 days of the required filing of the Annual Financial Statement. The owner’s share shall be twenty five (25) percent and will remain available to meet project obligations, including authorized distributions. The minimum annual payment will be applied towards interest first and then principal.
6. A call provision equal to the maturity date of the Use Agreement, at which time HUD, or the Second Note Holder, at their sole option, may require the full payment of, or provide the owner the opportunity to propose a restructuring of the debt.
7. Language prohibiting successors and assigns of the beneficiary of the Second Deed of Trust Note from imposing property insurance requirements that exceed the original principal balance contained in the First Mortgage Note or First Deed of Trust Note or are in addition to those required by the First Deed of Trust Holder or First Mortgage Note Holder so long as the First Mortgage Note or First Deed of Trust Note is insured by the Secretary of Housing and Urban Development.
8. HUD has the right to sell the HUD-Held Note. If HUD sells the HUD-Held note, the owner is required to submit annual financial statements to the NOTE HOLDER in the same form as submitted to HUD.

H. Other Terms and Conditions of the PPC transaction

1. If IOI expenditures have been included as an Owner’s Contribution in calculating eligibility for a PPC, then a requirement that those expenditures

cannot be taken or must be re-deposited for any year in which surplus cash is negative (not to exceed the amount of the negative surplus cash amount.) The redeposit or accrual can only be repaid from the owner's share of surplus cash in future years.

2. The monthly deposit to the Reserve for Replacement Account (RFR) will resume with the first payment of the recast first mortgage. (Previous deposits will not have to be made up, unless the reserve balance has been determined to be inadequate).
3. All escrows, such as tax, hazard insurance and mortgage insurance premium (MIP) shall be fully funded at closing.
4. All payables older than 30 days must be converted to notes payable and can only be repaid by the owner's share of surplus cash or paid by the owner prior to closing.
5. Under no circumstances may changes be made to the documents reviewed other than to conform to the terms and conditions of this approval, without HUD's specific authorization. The Hub/Program Center Counsel, in consultation with HQ Office of General Counsel, may modify the documents to conform to local legal requirements.
6. If the insured First Mortgage is repaid, the owner must establish and maintain continued funding of all escrows required by the First Mortgage until the second is repaid in full.
7. If at any time during the term of this agreement, HUD determines that there has been an uncorrected material violation of a Regulatory Agreement, Housing Assistance Payments Contract, Use Agreement, or any other contractual or Regulatory provision governing the operations of this project, the interest rate on the HUD-Held Second Mortgage will revert to the original Note Rate, the rate on the First Mortgage existing prior to the Modified Insured First Mortgage, retroactive to the date of the closing.
8. Project operating income may not be used to pay financing fees, attorney fees, consultant fees, other professional fees, or any other costs of the restructuring transaction. The owner's share of future surplus cash may be used for these purposes only if available for distribution in accordance with HUD regulatory requirements and applicable policy guidelines.
9. Cash held in suspense by the mortgagee will be allowed by HUD to be used at closing to pay reasonable closing attorney fees, title and recording fees, escrow shortages and interest for the remainder of the closing month. The PPC will not be increased if project cash is insufficient to cover these costs.

Questions relating to this ML should be directed to Norman Dailey, Housing Program Advisor at (202) 402-8371, Headquarters Office of Multifamily Asset Management.

/s/

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Assistant Secretary for Housing-
Federal Housing Commissioner