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FHA Increases Oversight of Multifamily Lenders and Underwriters

By Jennifer Dockery, Staff Writer, Novogradac & Company LLP

On July 6 the Federal Housing Administration (FHA) released Mortgage Letter (ML) 2010-21. The letter updates policies and outlines four major changes to FHA's multifamily rental programs: it revises underwriting standards; enhances verification of property financial performance; expands borrower mortgage credit analysis; and sets up a process for the prescreening of proposals. ML 2010-21 will have the greatest effect on market rate properties, but will also increase the loan costs for affordable housing properties.

The letter marks the first updates to FHA's underwriting standards since the agency began its multifamily program; FHA's Multifamily Program Office developed the new policies with the help of industry stakeholders and the changes took affect earlier this month.

"These policy changes reflect many of the lending industry's best practices and standards that have evolved in the multifamily market," said Carol Galante, U.S. Department of Housing and Urban Development (HUD) deputy assistant secretary.

"The guidance tightened the underwriting requirements for both market rate and affordable housing transactions, but HUD accommodated affordable housing transactions as much as possible," said David Cardwell, National Multi Housing Council's (NMHC's) vice president of capital markets and technology. "None of these changes will be well received by borrowers, but FHA still has the most generous underwriting terms compared to other sources of construction and mortgage credit," he added.

Revised Underwriting Standards

ML 2010-21 raises the debt service coverage ratios (DSCRs), lowers loan-to-value and loan-to-cost ratios, limits sponsor cash out, and increases project reserves and sponsor equity investment. FHA targeted underwriting ratios to different properties based on their risk profiles, with lower ratios for subsidized affordable housing properties. Section 221(d)(4) and 221(d)(3) loans have DSCRs of at least 1.11 and loan ratios of between 87 and 90 percent. Additionally, the FHA has decreased the underwriting occupancy maximum to 93 percent; increased construction contingency to 10 to 15 percent for substantial rehabilitation loans; and increased working capital in escrow to 4 percent. Properties must have an initial operating deposit of four months of debt service, release cash only after sustaining occupancy achievement and demonstrate an ability to stabilize within 18 months of completion.

Increased Scrutiny

The changes reflect HUD's desire to manage the risk of FHA's multifamily portfolio. ML 2010-21 provides increased scrutiny of loan applications. Enhanced verification of property financial performance will decrease opportunities for misrepresentation and fraud. Expanded borrower mortgage credit analysis will include a detailed review of contingent liabilities and ballooning term debt that could undermine a sponsor's financial stability. The proposal prescreening process will identify transactions that are not feasible or are unlikely to proceed to a commitment and allow staff to focus on a deeper analysis of transactions that will close.

"All of those initiatives are really meant to better manage the

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risk that the FHA is seeing in its portfolio," said Douglas Moritz, associate vice president of the Mortgage Bankers Association's (MBA's) commercial and multifamily group.

Industry Response

The individual items are not deal killers, but collectively, they may have greater impact, NMHC's Cardwell said. The additional information requirements will increase individual developer costs, but it is uncertain what the overall effect on the program will be.

"It's obviously going to affect everybody across the board. It's undetermined how significant that's going to be. It's going to be project by project," Cardwell said.

The MBA supports the tightening of FHA's underwriting standards. "It's only prudent that FHA join the rest of the lending community in tightening underwriting standards," Moritz said.

Margaret Allen, AGM Financial Services Inc.'s chief executive officer, said that it was understandable that the FHA would tighten its requirements because demand for HUD products is high right now. She estimated that demand for FHA loans has increased from an average of \$4 billion in previous years to around \$20 billion this year. The changes reflect a greater awareness of risk assessment; HUD does not want to see its default ratio increase as its lending increases.

More to Come

Allen, whose company is an FHA Mortgagee and Multifamily Accelerated Processing (MAP) lender, is concerned that the loan committee process will delay loan approval. A forthcoming mortgage letter is expected to establish a national loan committee to review all new FHA loans of more than \$15 million. Before the national committee reviews the loans, however, the field offices must prepare application packages for the loan committees. Allen estimates that 85 to 90 percent of FHA's loan requests fall into this category. Loan applicants are supposed to receive a response from the national loan committee in 10 days. The preparation of a loan committee package by the field offices that are already receiving four times the usual number of loan requests will add much more review time than the 10 days at the loan committee, Allen said. She believes that it may be more cost-effective to review only loan requests greater than \$50 million.

Developers and lenders have been preparing for the changes since HUD previewed them in February. Both are now subject to the tighter underwriting standards. The FHA plans to monitor the effect of the changes and may adjust the rules again in the near future. The agency also plans to implement additional underwriting changes throughout the rest of the year. The anticipated changes include additional experience and qualification

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reviews for multifamily underwriters and lenders, standardization of underwriter's narrative and application file contents, and a new loan approval process that aligns hub and program center commitment authority and practice. HUD also plans to publish an updated MAP guide by year's end. ♦

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