



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

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

August 26, 2009

MORTGAGEE LETTER 2009-26

MEMORANDUM TO: All FHA-Approved Multifamily Mortgagees

SUBJECT: Eligibility of Projects for Mortgage Insurance where Construction has Started

Purpose

This Mortgagee Letter (ML) temporarily authorizes and establishes policy for Section 220, 221(d) and 231 mortgage insurance programs to insure mortgages for multifamily proposals that were unable to complete construction due to a loss of funding. This temporary authority is limited to new construction proposals and waives the requirement that construction must not have started prior to making an application for a HUD-insured mortgage. Construction work completed prior to application submission must not have exceeded site preparation necessary to begin building construction and the completion of the foundation. The waiver authority granted under this ML expires six months from publication. The Department will evaluate the effectiveness of this waiver authority based upon applications received and may elect to extend the program based upon that evaluation.

Background

The Department has received requests to provide mortgage insurance for projects where construction stopped due to the loss of project financing or other sponsor circumstances. The amount of construction work completed ranges from limited work, such as site infrastructure, foundations and footings to those in more advanced stages of construction, such as a 90% completed condominium project that missed the homeowner market and decided to convert to rental. Industry data confirms that both the availability of credit and the existing supply of rental housing are contracting. Due to the illiquidity in the financial markets, lenders are reluctant to make construction loans and are backing out of commitments already made to provide construction draws. This tightening of credit will continue to depress current and future multifamily construction.

The above situations were not attempts to avoid the Department's requirements relating to Davis-Bacon wages or the required HUD inspections, since HUD-insured financing was not contemplated as part of their original development concept. The current policy prohibits construction to start prior to the issuance of the Firm Commitment. The policy contained herein ensures that the program's construction and design standards are applied to all elements of building construction prior to the Department assuming any risk and that the Department is fully protected under contractor warranty requirements.

Waiver Authority

As of the date of this ML, Hub Directors will have temporary authority to waive the current policy that prohibits the issuance of mortgage insurance in cases where construction has already started, for a six-month period subject to the conditions, requirements and instructions below. The requirements of this ML may not be waived by the Hub Directors.

Conditions, Requirements & Instructions

A. Eligibility

This waiver authority applies only to non HUD-insured new construction apartment projects that have started or completed site improvements and building foundation work. Substantial rehabilitation is not eligible. Foundation work includes footings, foundation walls, piers, grade beams, slabs, and under-slab utilities. Any project that falls under Section 232 is not eligible.

All construction work must have stopped before application submission. Construction financed under the FHA program should commence after Initial Endorsement. Early start requests should not be necessary since the work completed will have reached or surpassed current policy levels. However, the need to protect existing construction and eliminate any hazardous condition may be an exception.

The proposal must be feasible and demonstrate adequate market demand in consideration of the FHA mortgage term.

B. Application and Required Exhibits.

In addition to all other requirements for the applicable Section of the Act (SOA), the following requirements apply:

1. **Firm Applications Only.** Initial consultation between the Sponsor, Mortgagee and the local program center is strongly encouraged. However, the Department will not perform pre-application processing. Only applications for Firm Commitment will be accepted, along with the processing fee.
2. **MAP Processing.** MAP processing must be used except in cases where there is an Identity-of-Interest between the Mortgagor and Mortgagee.
3. **Evidence that Alternative Financing cannot be Obtained.** The applicant must submit documentation evidencing that efforts to obtain alternative financing have been unsuccessful and or that the current financing has been cancelled. This should include rejection letters from prospective Lenders and cancellation letters from Lenders that had previously committed financing. Acceptable documentation may also include a certification that credit is not available at reasonable rates and terms

without a commitment for FHA mortgage insurance. This certification should state the rates and terms that did not make it possible to receive the financial credit.

4. **Prior or Current Debt.** The applicant must submit evidence in writing that all interest and/or debt service payments have been made on time since the beginning of any existing or prior financing.
5. **Project Debt:** Existing project debt for these transactions **only** is defined as project debt incurred from the beginning of construction through construction stoppage, and supported by proper documentation. The borrower must submit evidence of all existing indebtedness, including hard and soft costs, incurred from the beginning of construction up to the construction stoppage date. (Examples of acceptable evidence are: a payoff letter from the original Mortgagee for the construction loan, any construction debt incurred and paid for by the Insurance Company on behalf of the Mortgagor must also be evidence by documentation from the Insurance Company). If the Mortgagor paid for construction cost (after the Lender ceased paying construction draws) from other sources, the source of these funds and evidence that the funds were for actual construction cost must be provided. (The unpaid construction draw may be submitted as evidence).
6. **Existing Construction Work/Documented Cost.** Acceptable documentation of the cost of work completed would include contractor's invoices, draw requests, and evidence that funds were disbursed, i.e., cancelled checks or receipts from the contractor or subcontractor. It is anticipated that the actual amount and type of documentation available will vary from case to case. The acceptability of the documentation is at the discretion of the Hub Director, in consultation with Headquarters as needed.
7. **Appraisal and Market Study.** An appraisal and market study are required exhibits. Due to the rapidly changing market conditions that many of these projects are subject to, the effective date of these reports must be within 60 days of the application for Firm Commitment. Updated reports are not acceptable. It is crucial that the Appraiser and Market Analyst not be biased by previous work completed on the same project or contract with prior parties to economize on the cost of the application. Therefore, the original Appraiser and Market Analyst should not be used unless specifically permitted by the processing office.
8. **Underwriting Summary.** Provide an Underwriting Summary that thoroughly addresses the reasons that justify a waiver, i.e., the reason construction stopped; past and current market conditions, and the creditworthiness of the Borrower and its key principals. The Underwriting Summary should be formatted to address these reasons in separate sections.

With respect to paragraphs B3, B4 and B6, above, all Hubs and Program centers are admonished that any suspected fraudulent activity must be referred to the Office of Inspector General.

C. Allowable Inclusions in the HUD-insured Mortgage

1. **The Costs of Work Completed.** The costs of work completed and approved by the Department may be included under FHA financing in accordance with the aforementioned documentation requirements.
2. **Protection and Security for the Existing Construction.** The costs of measures taken to secure and protect the existing construction and building materials on site after the date that an application was made for a HUD insured mortgage may be included, as well as, costs incurred to address hazardous site conditions.
3. **Additional Reports Required by the Processing Office.** The cost of additional reports required by the processing office (i.e. engineering reports required by A/E and Cost) may be included.
4. **Design Modification.** The cost of HUD or code mandated changes to the plans may be included.
5. **Building Materials.** The cost of building materials that are currently on site may be included so long as A/E and Cost staff deem them to be acceptable for incorporation into the project.

D. Exclusions from the HUD-insured Mortgage

Demolition of and/or Repair Work for the Existing Construction. Onsite work to remove defective existing structures, footings, foundations, and utilities, or repair work needed on the existing construction must not be included and will be a cash requirement at initial endorsement.

E. Davis-Bacon Wage Requirements.

Eligibility criteria for waiver authority include that only minimal construction may have been completed and all construction work must cease prior to application for Firm Commitment, and that construction work financed under the FHA program should commence after initial endorsement. Based on these criteria and consultation with the Department of Labor, HUD has concluded that construction work completed prior to the application for Firm Commitment shall not be subject to Davis-Bacon requirements. Any construction work undertaken after the application for Firm Commitment, including any demolition and/or repair of existing construction, shall be subject to Davis-Bacon wage and reporting requirements. In those limited circumstances where permission is granted for construction work to commence after the application and prior to initial endorsement, the applicable wage decision shall be the wage decision appropriate to the type of construction involved (e.g., residential or building) that is in effect on the date such work begins. Where

construction work commences on or after initial endorsement, the applicable wage decision shall be the wage decision appropriate to the type of construction involved that is in effect on the date the mortgage is initially endorsed provided that construction begins within 90 days after initial endorsement. If construction commences more than 90 days after initial endorsement is made, the applicable wage decision is that which is appropriate and current at construction start. The applicable wage decision and the HUD-2554, Supplementary Conditions to the Contract for Construction, must be incorporated into the construction contract.

F. Application Processing – A/E and Cost

HUD Architectural/Engineering (A/E) staff will inspect the site and evaluate the work completed to assess its soundness and that construction was in accordance with the Department's standards. A/E staff may also rely on inspections that were completed by the municipal authority. In addition, A/E staff may require the Sponsor to obtain and pay for additional third party inspections such as an evaluation by a licensed structural engineer.

1. In addition to the Lender's Architectural Analyst's duties outlined in our current guidelines, the Analyst will:
 - a. Obtain and review all building permits,
 - b. Obtain and review copies of approved construction documents,
 - c. Obtain and review copies of all code inspections, and
 - d. Obtain and review copies of architect's, Engineer's, Soils Engineer's and Contractor's inspections.

2. In addition to the existing site visit requirements, the Architectural Analyst will:
 - a. Review the existing construction to assure himself that it conforms to the construction documents, is of acceptable quality, and is still suitable for incorporation into the project. Existing construction that is no longer acceptable due to excessive deterioration must be removed and replaced. If this demolition and corrective work is completed after an application for mortgage insurance is made, the work is subject to Davis-Bacon Requirements.
 - b. Note any material, and its condition, stored on-site that is to be incorporated into the project. Material that is deteriorated due to excessive weathering or other damage must be removed and may not be used for the project.
 - c. Note the condition of the soil. Soil that may have been acceptable at one time may now be unacceptable due to excessive moisture.

3. The project must have been designed by a licensed professional as defined by our current requirements. An owner-architect agreement, AIA B181, meeting the Department's current requirements will be executed for construction supervision. Document B181 will also be executed for any further revisions to the construction documents required to meet HUD's or the locality's requirements in so far as this work is not covered by the existing owner-architect agreement. The Lender and HUD will review the existing agreement to assure themselves that it is substantially equivalent to the B181. The original construction documents and permits (if current) may be used, subject to review by A/E staff. Modifications to the plans may be required to comply with the Department's requirements.
4. The Geotechnical Engineer who made the original soils study and monitored construction must certify that the soils remain suitable for construction. If necessary, further soils investigation must be made.
5. HUD will require assurance that existing work will be finally accepted and warranted. This assurance may be in the form of an escrow of 25% of the cost of existing work, or inclusion of existing work into the HUD-92452, Performance Bond, by amendment, as well as inclusion into the standard one-year builder's warranty by amendment to the construction contract.

Cost Processing will be completed as per current requirements. However, the cost of the existing improvements will not be included in Section G, line 50, Total For All Improvements, Form HUD-92264.

G. Application Processing – Valuation, Market Study and Environmental

1. **Statement on the Current Condition of the Market.** Both the appraisal and market study must address in the cover letter or executive summary whether or not the subject proposal is feasible and demonstrate adequate market demand in consideration of the FHA mortgage term.
2. **Market Study.** The market study must comply with all existing requirements, especially the following:
 - a. It is extremely important that the data and estimates provided should be relevant and current. Conclusions in the analysis must be consistent with the facts presented. Findings and recommendations should be based on a reasonable forecast of market supply/demand conditions and sound assumptions regarding capture rates, absorption, achievable rents, income affordability and similar factors.
 - b. An assessment of whether the development of the proposed project would adversely affect the existing rental inventory is required. Particular attention should be given to the impact on other HUD insured properties.
 - c. Also, all reference sources must be clearly identified with contact

information provided to allow for an efficient review by HUD staff.

3. **EMAD.** EMAD must review the market study prior to issuing the Firm Commitment.
4. **Appraisal.** The appraisal must comply with all existing requirements. In these cases, it must be stressed that the most current data, including offerings, pending transactions and absorption be used with the following guidance:
 - a. It is particularly important to insure that active listings and pending sales for land sale comparables or rental comparables are market tested and have reasonable exposure time to avoid the use of overpriced properties as comparables. Reasonable exposure is reflected by typical marketing times for the market area.
 - b. Adjust offerings, as appropriate, to reflect list/sold ratios for the market.
 - c. Although there is a separate market study, the Appraiser must pay special attention and provide an accurate absorption rate analysis to allow for a realistic estimate of the operating deficit.
5. **Occupancy and Commercial Space.** The current limitations on commercial space and occupancy may only be waived by headquarters.
6. **Operating Deficit/Marketing Expense.** The Lender should carefully review the Appraiser's estimate of the operating deficit to assure that it reflects the estimates of absorption made by the Appraiser and Market Analyst. Significant differences between these estimates must be reconciled and discussed in the underwriting summary. Also, special attention needs to be paid to the adequacy of the marketing expense. It is important to note that marketing expense should be significantly higher in early stages of rent-up.
7. **Warranted Price of Land.** The Warranted Price of Land shall not include the cost or value of the existing construction. This item will be listed separately by adding a line under 73c of the form HUD 92264. Simply insert a new line, 73d and label it "Documented Cost of Existing Construction." This amount will be added along with the Warranted Price of the Land to determine the estimated replacement cost of the project.
8. **Environmental Processing.** The applicant must submit a current Phase I Environmental Site Assessment meeting the requirements of ASTM 1527-05. The Phase I should reference any environmental analyses and these older reports should be submitted also. The HUD Review Appraiser will complete the environmental review in accordance with current requirements under HUD regulations at 24 CFR part 50. No physical or choice-limiting

activities may be undertaken until the applicant receives notification that the review is complete and work may begin.

H. Additional Requirements.

All other program requirements for the applicable SOA must be met, including compliance with the nondiscrimination provisions of the Fair Housing Act, the submission of an Affirmative Fair Housing Marketing Plan, and compliance with the Americans with Disabilities Act (ADA) along with Executive Order 11063 regarding concerns on accessibility requirements for persons with disabilities.

David H. Stevens, Assistant Secretary for Housing -
Federal Housing Commissioner