May 3, 2017

TO: State Directors
Rural Development

ATTN: Program Directors
Multi-Family Housing

FROM: Richard A. Davis /s/ ***Richard A. Davis***
Acting Administrator
Rural Housing Service

SUBJECT: Guidance on Refinancing Existing Loans in the Section 538 Guaranteed Rural Rental Housing Program (GRRHP)

The intent of this Unnumbered Letter (UL) is to provide guidance on loan refinancing for existing properties with Section 538 GRRHP loan guarantees where the Agency determines that refinancing is in the best interest of the Government or the program. This UL is written for the sole use of the Rural Development (RD) State Office and Area Office staff involved in processing Section 538 guaranteed loan refinancing. HB-1-3565 will be revised to include program requirements specified in this UL.

Refinancing is not available for non-Agency properties nor combination Sections 515/538 transactions. Section 538 GRRHP borrowers and lenders may agree to a loan refinance when the action will improve the financial viability of the project and its operations.

To request a loan refinance, the incumbent lender will submit to the Agency required application documents. A refinance is considered a new loan and therefore, the lender will submit a new Notice of Solicitation of Application (NOSA) response/pre-application and a full application (once the Notice to proceed is issued). The attachment provides items that must be included in the Lender's Narrative in addition to the current program requirements.

EXPIRATION DATE:
May 31, 2018

FILING INSTRUCIONS:
Housing Programs

<u>Refinance Program Requirements</u>:

Pre-Meetings. Once the Agency has been notified of the lenders refinance intentions, there should be a meeting or call set-up with the lender to establish Agency timelines for processing the refinance application as well as to discuss any potential issues that may arise in the transaction. There should also be a meeting held with the lender's identified appraiser and Rural Development (RD) appraisal staff to ensure appropriate guidance is given to the appraiser regarding program requirements. Additionally, if there are non-compliance issues outstanding from the last Annual Report, this meeting can be used to discuss those items and determine if a Loan Modification-Interest Rate Reduction transaction is a better option.

Eligible Properties. Any existing Section 538 property. Refinancing is not available for non-Agency properties nor combination Sections 515/538 transactions. The majority of the Sections 515/538 loan closings have occurred over the past five years and therefore, these loans are not seasoned enough to benefit from a refinance because of the recent low interest rate environment and lack of equity built up in these properties.

Program Fees. The following fees have been determined necessary to cover the projected cost of loan guarantees. These fees may be adjusted in future years. The fees will be published in a Notice in the <u>Federal</u> <u>Register</u>.

Current fees are as follows:

1. **Initial Guarantee Fee.** The Agency will charge an initial guarantee fee equal to 1 percent of the guarantee principal amount.
2. **Annual Guarantee Fee.** An annual guarantee fee of 50 basis points (1/2 percent) of the outstanding principal amount of the loan as of December 31, will be charged each year or portion of a year that the guarantee is outstanding.
3. **Application Fee.** There is no application fee.

Eligible Use of Funds. Lenders must certify that all of the proceeds of the guaranteed loan will be used for eligible purposes as set forth in *[7 CFR 3565.205]*.

Cash-Out. Cash-out is permitted. On a cash-out refinance transaction, cash-out will be limited to 70 percent of restricted value. If the transaction involves repairs of the property, to ensure that repair/rehabilitation has been satisfactorily completed, only 50 percent of the cash-out will be released at closing. The remaining 50 percent will be held in escrow by the lender until completion and inspection of required repair items is complete. The Agency will verify the cash out escrow bank balance as specified by the lender certification. Cash-out is not available for existing loans that are on a work-out plan.

All cash-out refinance transactions that are approved by the State Office must be submitted to Headquarters (HQ) for concurrence. At a minimum, the State Office will provide the following documents to HQ for evaluation:

- *Loan Application*, RD Form 3565-1
- Transaction Summary
- The most recent and interim financial statements with lender analysis
- Sources and Uses Statement

Interest Credit. The interest credit is tied to a specific loan. When a loan with interest credit is paid off, the interest credit is terminated. Interest credit cannot be transferred to the refinanced loan.

Capital Needs Assessment (CNA). A new CNA is required on all refinance transactions.

Appraisal. See HB-1-3565 3.28 APPRAISAL REQUIREMENTS.
A current appraisal of the property must be submitted with the application for refinance. An appraisal is current if it is less than one year old from the effective date of the valuation.

Appraisers must be independent of the loan production and collection processes and have no direct, indirect or prospective interest, financial or otherwise, in the property or transaction.

The appraisal shall reflect the market value of the subject property defined in 12 CFR 34.42, Title XI of FIRREA. The appraisal must consider all restrictions applicable to the property as of the effective and/or prospective dates of valuation.

Environmental Review. See HB-1-3565 1.17 ENVIRONMENTAL REQUIREMENTS, the Rural Housing Service (RHS) has responsibilities to comply with various environmental laws and regulations. Lenders' submission requirements assist in this review.

Escrow and Replacement Reserve Accounts. Both the existing Replacement Reserve and Tax and Insurance Reserve accounts must remain with the project. The borrower must submit a list of escrows currently on deposit for the project; minimum annual deposit thresholds must meet GRRHP guidelines, Initial Deposit and Annual Deposits (IDAD) must be made to the Reserve for Replacements in accordance with the CNA, underwriting and appraisal and subsequently made from project operating income to monthly and annual deposit minimums. Underfunded reserve amounts may be eligible for inclusion in the maximum guaranteed mortgage.

Fair Housing Act Non-Compliance. Any property available for first occupancy after March 13, 1991, that is in non-compliance with the Fair Housing Act design and construction requirements, must, as a condition of Guarantee, be modified/retrofitted to comply with the Fair Housing Act accessibility guidelines.

Labor Standards. Davis-Bacon prevailing wage requirements do not apply to a Section 538 refinance.

Mortgage Loan Terms. The maximum term of the mortgage is 40 years, or the remaining economic life of the property and the term may not be less than 25 years. The remaining economic life of the property available for refinance should be identified within the appraisal of the property.

Interest Rate. The fixed interest rate on a guaranteed loan is negotiated between the borrower and the lender and must be locked prior to closing of the new loan. Payment of discounts by the mortgagor to buy down an interest rate is acceptable during negotiations prior to closing of the new guaranteed loan.

Prepayment. A guaranteed loan may be prepaid in whole or in part at the determination of the lender, and upon the lender's written notice to the Agency at least 30 days prior to the expected date of prepayment. The Agency will not pay any lockout or prepayment penalty assessed by the lender. When the refinancing is being performed by a different firm than the one that currently services the loan, a letter accompanying the application and signed by the borrower must be provided to the servicing lender notifying them of their intent to refinance and prepay.

Lender Fees and Charges. For Section 538 refinancing, placement fees the lender may charge are negotiated between lender and borrower(s). Permissible fees can consist of any combination of origination, financing, and permanent placement fees and can also include the lender's legal fee. Financing and placement fees in bond transactions may slightly differ. Third-party costs (e.g., appraisal, market study, CNA, and other organization costs) may be included as mortgageable costs in the mortgage. The lender is prohibited from advancing fees for payment of discount fees on behalf of the borrower (*[7 CFR 3565.206]* provides guidance on ineligible uses of loan proceeds). The lender may pay pre-payment penalties on behalf of the borrower, so long as this is disclosed to and approved in advance by RHS.

Secondary Financing. RHS guaranteed mortgages must be first liens. Secondary liens may be permitted and must be approved by RHS prior to loan closing.

Recent Indebtedness. RHS does not recognize indebtedness recently placed against the project to increase the mortgage or circumvent program intent. "Recent indebtedness" for multifamily properties is defined as any debt incurred up to one (1) year before the submission of an application for mortgage.

Regulatory Agreement. All borrowers must execute a new Regulatory Agreement governing the operation of the project. The Regulatory Agreement is recorded at closing.

Underwritten Occupancy. Underwritten vacancy will be the lesser of the minimum levels shown below and actual levels. The lender's third-party appraiser should use actual vacancy rates, the minimum vacancy rates and loan-to-values allowed for underwriting and sizing mortgages determined with debt service calculations. Underwritten Vacancy Rates are as follows:

Minimum Vacancy:

- **3 percent -** for properties with rental subsidy and/or HUD Housing Assistance Payments (HAP) contract covering 90 percent or more of the units; or occupancy at or above 90 percent, and 90 percent or more of the units set aside as LIHTC units, and Attainable Tax Credit rents at least 10 percent below market.
- **5 percent** - Properties with 80 percent or more of the units set aside as LIHTC units, and Attainable Tax Credit rents at a 10 percent discount to market.
- **7 percent** - LIHTC properties with any percentage of units set aside but without a 10 percent discount to market; or properties in which 20 percent or more of the units are market rate.

The borrower must submit the most recent financial statements, submit a year-to-date balance sheet and operating statement, copies of the most recent insurance and property tax bills, history of stabilized occupancy and financial performance. Borrower-certified year-to-date statements may also be acceptable.

Debt-Service Coverage Ratio (DSCR). Projects must be underwritten by lender to meet the established DSCR of 1.15.

Site Inspection. The lender's certification shall include a copy of the most recent site inspection. Additionally, a Rural Development employee should visit the site of the proposed financed project whenever possible. No health and safety issues should be present at closing.

Office of General Counsel (OGC) Review. The Agency reserves the right to send closing documents to OGC for review. For example, there may be a change in the partnership agreement.

Annual Audits. The Agency will review the most recent annual report to ensure that the lender addresses all deficiencies in their refinance lender narrative, should deficiencies exist. These deficiencies include but are not limited to DSCR, property inspections, and management plans.

Data Tracking. Update Guaranteed Loan System (GLS) to reflect that the loan is a refinance. A new check box is anticipated in 2017. However, if the GLS system does not have the check box for refinance, enter "REFINANCE" in the NOFA response COMMENT section of GLS.

Finance Office Notification. Once the Agency's loan closing transaction has processed and a new *Loan Note Guarantee* has been issued, the Finance Office should be notified to terminate the original guarantee. Notifications may be made to the appropriate National Finance and Accounting Operations Center representative for your State.

Checklist. A refinance application checklist will be added to the SharePoint site to assist with processing the refinance transaction.

If you have any questions regarding this UL, please contact Michael Steininger, Director, Multi-Family Housing Guaranteed Loan Division at (202) 720-1610 or via e-mail: michael.steininger@wdc.usda.gov or Monica Cole at (202) 720-1251 or via e-mail: monica.cole@wdc.usda.gov.

Attachment – Lender's Narrative and Underwriting Summary Additional Requirements

Attachment

In addition to current program requirements, the section 538 Refinance Lender's Narrative & Underwriting Summary must include:

Property History. Include historical occupancy rates. The subject project vacancy levels noted by quarterly/yearly for the past three years as follows:

Year	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Annual Average
20XX					
20XX					
20XX					

Replacement Reserve. The existing initial deposit to the reserve for replacements and reserve for replacement account(s) must remain with the project. The borrower must submit a list of escrows currently on deposit for the project; minimum annual deposit thresholds must meet GRRHP guidelines, IDAD must be made to the Reserve for Replacements in accordance with the CNA, underwriting and appraisal conclusions and subsequently made from project operating income to monthly and annual deposit minimums. Underfunded reserve amounts may be eligible for inclusion in the maximum guaranteed mortgage.

Existing Replacement Reserve Balance	Annual Amount Per Unit
$	**$**

Improvements/Physical Needs. Discuss repairs (if any) to include cost, type, timing, completion and include discussion of tenant relocation if applicable. Provide a list of repairs that have been completed over the past two years.

Management and Ownership. Discuss if there will be any management changes and or changes to the organization/ownership structure. Provide an organizational chart outlining percentage of ownership for mortgagor and all principals of the mortgagor. Verify that the underwriter has reviewed the organizational documents of the mortgagor entity and has found them to be acceptable. Provide current and proposed organizational chart (if applicable).

Legal and Other Issues. Lender is to certify there is no pending litigation involving the mortgagor, its principals or the project and that there are no identified title issues.

Underwriting Conclusion/Conditions. Discuss the underwriting conclusion and any conditions for the transaction.