August 28, 2012

TO: State Directors
Rural Development

ATTN: Program Directors
Multi-Family Housing

FROM: Tammye Treviño *__(Signed by Tammye Treviño)__*
Administrator
Housing and Community Facilities Programs

SUBJECT: Dynamic Servicing Strategies for the Multi-Family Housing
Direct Loan Portfolio

This Unnumbered Letter (UL) is being re-issued to highlight steps to be taken in evaluating and resolving servicing actions related to defaulted properties in the Multi-Family Housing (MFH) Programs' Direct Loan portfolio.

MFH has become increasingly concerned about its affordable housing properties, particularly those properties in default due to physical, financial or management issues. The objective of MFH's dynamic servicing efforts is to intensify actions on defaulted properties in order to bring resolution in a timely manner. To ensure that our tenants continue to be provided decent, safe and affordable housing, MFH will continue its efforts to assess its portfolio and focus on its troubled properties.

There are two important components in this process:

a) Evaluate your State's MFH portfolio for continued resource investment, and
b) Take appropriate servicing actions promptly on defaulted loans.

EXPIRATION DATE:
August 31, 2013

FILING INSTRUCTIONS
Housing Programs

The two general components in this process are broken down into Action Summary steps. Each step in the Action summary table is explained in detail following the table.

Step	Action	Guidance
1	Determine appropriate classification of projects in the portfolio	Correct the Multi-Family Information System database (MFIS) information if needed.
2	Complete or update the assessment of your State's portfolio and categorize within 60-90 days of this UL.	Use guidance in this UL.
3	Focus on "D" properties with no Rural Housing Service (RHS) servicing action in last 3 months	Determine servicing action(s) to be taken immediately; after implementing the servicing actions for these "D" properties, review remaining "D" properties for appropriate action and implement those servicing actions.
4	Complete required Suitability Analysis	Use HB-3-3560 Chapter 6 to determine whether property should remain in the program.
5	Send series of servicing letters in accordance with handbook requirements	Servicing letters must be sent within the timeframes provided in the handbook; provide proper notice to borrower; ensure all citations are correct
6	Meet with borrower	Establish a workout agreement, if possible.
7	Develop acceptable, comprehensive workout plan within 60 days of meeting with the borrower.	A workout plan that addresses all open findings changes the property classification to a "B".
8	If no action, prepare Problem Case Report in accordance with handbook requirements	Note 7 CFR §3560.453(b) and HB-3-3560 Chapter 10, Section 10.23, which state that approval of a workout plan is not guaranteed to a borrower.
9	Accelerate account	Follow guidance in Rural Development Voucher Guidebook to order a Rent Comparability Study (RCS). If accepting a deed-in-lieu or payoff of accelerated account, order RCS immediately. Otherwise, follow foreclosure guidance.

Step 1: Determine that all properties have been appropriately classified

A recent National Office review of the MFIS database revealed that some properties are not appropriately classified because MFIS has not been updated to reflect recent activity related to the project. In addition, projects are miscoded or improperly set-up. In order to properly service MFH loans, it is important to have accurate information. There are also some projects now classified as "D" because borrowers are unable to make the last payment, as doing so would result in paying off their loan ahead of the maturity date. This would be a prepayment and borrowers would need to follow the prepayment requirements in 7 CFR 3560, subpart N and HB-3-3560, Chapter 15. These borrowers should be offered a re-amortization at same or new rates and terms, and then properly classified. These efforts should be completed within 30 days of this UL.

Step 2: Complete an assessment of your State's portfolio for continued investment

The next step requires a thoughtful evaluation of your State portfolio. In order for MFH to target and prioritize the use of limited resources, this assessment will lay the foundation for dealing with serious servicing issues, including development of a workout plan, and completion of the Suitability Analysis pursuant to HB-3-3560, Chapter 6. In addition, budgetary constraints require the Loan Servicer to be realistic in his assessment of the viability of a property.

This initiative began with the Rural Rental Housing Comprehensive Property Assessment and Portfolio Analysis (CPA) completed in 2004, which was an effort to identify the physical condition and market viability of the Section 515 portfolio. The CPA found that MFH properties are generally in good shape but aging, and that reserves are underfunded. A copy of the report can be viewed at:
http://www.rurdev.usda.gov/rhs/mfh/Property%20Assessment/Property%20Assessment.htm

Over the past several years, MFH has been working towards a comprehensive strategy to deal with the Section 515 and Section 514 loan portfolios: 1) regulations were consolidated which resulted in 7 CFR part 3560; 2) Capital Needs Assessments (CNA) became an integral part of assuring the long-term viability of a property by capturing and reporting the long-range capital needs of a property; 3) management of Rental Assistance (RA) was improved through the monitoring of use and re-use of RA, and the number of rent overburdened tenants was substantially reduced; 4) a variety of loan account management tools was designed to boost the reserve account through implementation of the Multi-Family Preservation and Revitalization (MPR) Program; and 5) the Rural Development Voucher program was instituted to protect tenants in Section 515 properties where the mortgage is paid off prior to the original loan maturity date, either through traditional prepayment or foreclosure.

A follow-up report to the CPA, titled Developing a Strategy for Prioritizing Multifamily Revitalization (October 28, 2008) identified three categories of properties in MFH's portfolio:

- Category 1: property is needed but is in a strong market; very expensive to Rural Development to preserve;
- Category 2: property is needed and suitable for revitalization because it is in a good market, is well-performing or remains viable despite limited chronic vacancies;

- Category 3: property is no longer needed in the program or is too expensive for the owner to maintain.

Category 1	Category 2	Category 3
Needed, but Too Expensive to Preserve Properties that meet one of the conditions below: a) Cost to Rural Development to revitalize (rehabilitation loan + MPR tools) exceeds 50% of estimated replacement cost; or b) Preservation funding is not available; or c) Property is in a strong market with market rents that are affordable to moderate-income households; or d) RA is not needed to keep property viable.	Needed and Preservable Properties that meet one of the conditions below: a) Good market, good property and modest cost to revitalize (less than 50% of replacement cost estimate); or b) Recent rehabilitation and rents remain at or below Conventional Rents for Comparable Units (CRCU); or c) Moderate market and project cash flows but chronic moderate vacancy.	Not Needed or Revitalization is not Financially Feasible Properties that meet one of the conditions below: a) Weak market and weak property; or b) weak financials and rents cannot be held at CRCU; or c) Property has chronic high vacancy and other affordable housing available to meet needs.
Solution: If the property meets the prepayment requirements at 7 CFR 2560, subpart N and leaves the portfolio: a) Make Rural Development Vouchers available to tenants, or b) If property remains in the portfolio, remove RA as assisted tenants vacate.	Solution: Institute a suitable workout plan, or revitalize using an appropriate mix of MPR tools, or facilitate an efficient transfer.	Solution: Use necessary servicing actions, including compromise offers, debt settlement, or foreclosure, and make Rural Development Vouchers available to tenants.

Each State should classify its portfolio using these categories and have a different stratification of these types of properties in their portfolio. For example, some will have more or less of Category 2 than other States. Determining the appropriate category for each property will better equip Rural Development staff in making resource decisions. This analysis should be an on-going exercise to be sure property changes are captured and considered. Consistency regarding application of the factors below is an important objective of this strategy. The data collection tool will help ensure this consistency.

It is important to stress that MFH does not and cannot advocate methods to move properties to prepayment. Requesting mortgage prepayment is solely a decision by the borrower and prepayment requests must continue to follow the process outlined in Chapter 15 of HB-3-3560. In order to determine how properties should be categorized, use the following tools:

A. Evaluation Tools and Asset Data Collection

The U.S. Department of Agriculture Economic Research Service has developed extensive mapping on a state- and county-basis, which include indicators for population, employment, and income. States can access population shift and growth information for 2010-2011 at the following URL: http://www.ers.usda.gov/Data/Population/. Other State facts to consider when evaluating properties such as income, education, employment, Federal funds, are found at http://www.ers.usda.gov/StateFacts/.

B. Property and Marketing Factors

Listed below are some property and market factors that, taken together, can assist you in evaluating the properties in your portfolio. These parameters are not comprehensive but are based on the CPA findings, HB-3-3560, Chapter 6, and discussions with program directors. There may be others particular to your state that should also be considered.

Factor 1: Transition Events

Identify if the property is eligible to prepay the Rural Development mortgage, is reaching the expiration of tax credit eligibility, or is coming up on the natural maturity of the Rural Development mortgage.

Factor 2: Revitalization Cost vs. New Construction/Replacement Cost

Consider the cost to rehabilitate the property compared to building a new, comparable property. Rural Development's share, including a rehabilitation loan and the cost of MPR loan tools (if available), should not exceed 50 percent of the cost of new construction. The property may still be needed in the market, but it is too expensive for Rural Development to fund. Conversely, preservation funding may not be available, even for a property where Rural Development's portion of the cost is less than 50 percent. An alternative to consider is subordinating Rural Development's position to enable the borrower to obtain rehabilitation financing from a third-party. Low-Income Housing Tax Credits are one form of financing. Subordinations can only occur if the requirements of 7 CFR §3560.409 are met.

Factor 3: Management Problems

Consider if the property is experiencing current and/or ongoing problems with property management (either on-site or off-site) in responding to property compliance issues, aggressive marketing of the property to broad income-eligible groups, resolution of health and safety needs, and cooperation with Rural Development MFH staff instructions; also look at whether management routinely fails to follow-through with required actions in relation to work out plans, transition plans and property maintenance needs.

Factor 4: Physical Standards

Determine if there is physical deterioration and extensive deferred maintenance. Other signs of physical stress are unresolved physical condition problems from annual inspections or supervisory visits, also known as "open physical findings", media reports of the property's poor conditions, and tenant complaints.

Factor 5: Ownership Problems

Consider if ownership has been uncooperative and non-compliant with Rural Development requirements. Uncooperative ownership can result in deferred maintenance, low occupancy, high accounts payable, and financial viability problems.

Factor 6: Ongoing Health and Safety Issues

Consider if the property is experiencing problems that are of a health and safety nature that the owner/management has been unsuccessful in resolving. This may involve a re-occurring condition and/or a situation that has failed to be adequately addressed at all by the owner/ management. Some health and safety issues (e.g., structural problems, extensive mold) may be so pervasive that there is no financially-feasible remediation, at which point the account may need to be accelerated.

Factor 7: Properties in High Growth Areas

Consider if the property was located in an eligible rural area when construction but, due to population growth, is now located in an ineligible area for Rural Development programs. Determine if there is still a market need for this property, now likely in a high rent area. If the property has a vacancy problem, that may be an indication of a lack of market need for the project or it could indicate a management problem. If MFH determines that subsidy is no longer needed for the benefit of tenants, MFH may, upon written notice, suspend, modify or terminate form RD-3560-9 "Multiple Family Housing Interest Credit Agreement".

Factor 8: Market Demand/Vacancy Rates/Need

Consider if the market demand for the property has decreased significantly creating a high vacancy rate (in excess of 15 percent over the last two years). The high vacancy may have resulted in a lack of adequate cash flow and drained the property of financial resources. Also, determine if there are other Rural Development properties within the market area (e.g., the county) or a reasonable distance and, whether those properties are experiencing high vacancy rates.

If other Rural Development properties are experiencing high vacancies, the State should consider which of the properties in that county should be considered for Category 3 so that the remaining portfolio will have sufficient demand. Also evaluate the status of waiting lists and unit turnover frequency and downtime.

Factor 9: Population Growth/Projections

Consider if the property is located in an area that is in the process or has experienced a significant population change that has a negative effect on the continued successful operation. Examples include: i) the population in the area has declined, which likely will reduce the demand for housing; ii) the population will decline in the future, likely reducing housing demand in the coming years; and iii) there is a local factor that will reduce population or housing demand such as a plant closing that causes families to move out of the area, the effects of a natural disaster, and/or an economic crisis impacting the area. Population change could also be an increase. Also, to the extent that this information is available, consider the population age groups that have increased/decreased as this may affect the market for the project. In some areas, the overall population is stable but the portion of the population that is most likely to use Rural Development properties is declining and this will negatively affect housing demand.

Factor 10: Availability of other Affordable Housing Nearby

Consider if the property is located in close proximity to other subsidized/affordable housing units (Tax Credit, Section 538 Guaranteed Rural Rental Housing, Section 8, or even market rate properties) that, in effect, reduce the demand for Rural Development property units, i.e., the need for the property is no longer there. This condition may be ongoing or the property is just beginning to experience vacancies as a result of new development within the immediate vicinity. Consider, for this specific property, what is the true market area: i.e., where would existing tenants go for new housing? Include consideration of the Rural Development Voucher Program, which is available to low-income tenants of Section 515 properties that prepay or are foreclosed by the Agency.

Factor 11: Economic Viability

Consider if the property is economically viable. Does it have a difficult time generating sufficient income to pay essential expenses, fund the reserve account and make loan payments? Evaluate financial stresses on the property and their cause: are they resolvable?

Factor 12: Environmental Factors

Consider if there are businesses or facilities located nearby that would be undesirable as neighbors, and may affect marketability of the property to prospective tenants. Are any such plants, facilities or industrial parks planned that may negatively impact the property? Are there sufficient and adequate services located nearby? Are there stable, growing or declining employment opportunities? Is there social deterioration in the neighborhood and/or an increase in crime?

Create and Maintain a List of Your Properties

Using as a guide the three broad categories and the assessment measures above, discuss with your servicing staff your State's MFH portfolio. Identify the appropriate category for each property. Proactively service those projects that are viable and needed in the program. For those properties with monetary and nonmonetary compliance problems, initiate the series of servicing letters. Varying factors may affect the category of the State's properties over time. It will be necessary to determine an appropriate schedule to re-assess the portfolio.

Step 3: Focus on "D" properties with no RHS servicing action in last 3 months

Once properties are appropriately classified and you have completed an assessment of the portfolio, focus your efforts on the "D" classified properties. The assessment would have provided you with a priority order of properties demanding attention. Concentrate first on properties classified "D" where no servicing action has occurred in the last 3 months. This includes a significant number of properties that have been delinquent for over 180 days without evidence of forceful action despite their default status. Loan Servicers must take the steps outlined and summarized here to show action with regard to these languishing properties. Your next priority should be the remaining "D" properties, then "C" properties that you believe are on the verge of either monetary or non-monetary default.

Step 4: Conduct the Suitability Analysis (HB-3-3560, Chapter 6)

Loan Servicers will need to complete a suitability analysis as detailed in HB-3-3560, Chapter 6 to determine whether the property should remain in the program or be designated a non-program property. This analysis can be done at any time; the state's portfolio assessment in Step 1 may have provided a preliminary indication whether the property should remain or be designated non-program. The ultimate finding of the analysis; however, is: if a project is suitable, it is in the best interest of the Government to proceed with the servicing action. However, if the Agency determines that a project is no longer suitable, the Agency may designate it as non-program rather than spend limited Agency resources on a project that does not fulfill the goals of the program.

Chapter 6 provides information on next appropriate actions if the project is considered suitable to remain in the program.

Servicing Strategies

The portfolio assessment should have provided a good base for identifying project problems. The evaluation should be considered in conjunction with HB-3-3560 Chapter 10, which provides guidance to ascertain the source of the project problem and if it can be resolved to the satisfaction of all. If it cannot be resolved, you must determine what the next step will be. While the Agency would prefer to recover all of its funds, the two primary concerns MFH has are 1) protection of the tenants (from irresponsible owners or managers, from harmful living conditions, from the loss of affordable housing) and 2) ensuring that Government funds (as financing and subsidy) are used effectively and efficiently.

Summarized below are Chapter 10 highlights and specific points to remember. Loan Servicers should review the entire chapter.

HIGHLIGHTS OF HB-3-3560, CHAPTER 10

When routine monitoring of projects reveals noncompliance with program requirements, the Field Office must take immediate steps to notify the borrower and state the need for timely corrective actions.

Loan Servicers should be firm in dealing with the borrower or the borrower's representative in matters of compliance violations. Because the management agent is not the party ultimately responsible for the loan, it is imperative that the borrower be directly apprised of and fully understands the consequences of default. A noncompliance situation is often resolved or deterred through a workout agreement.

1. Types of Default
    - Monetary Default – when an account is delinquent more than 30 days (7 CFR §3560.452(b)).
    - Nonmonetary Default – when borrower fails to correct a compliance violation, other than monetary amount, within the time period specified in the compliance violation notice (7 CFR §3560.452(c)).

2. Notification to Borrower of Servicing Problems
    - Preliminary Notification : a) (Monetary) when a borrower becomes delinquent on a payment, an automatically generated Delinquency Billing Statement is mailed to the borrower. b) (Nonmonetary) during an on-site monitoring visit the monitors should meet with the borrower to review the initial results of the visit, including a discussion of compliance violations. A letter documenting this review should also be sent immediately after the visit.
    - Servicing Letter #1 - (Monetary) sent no later than when payment is 35 days past due. (Nonmonetary) sent upon evidence of violation and no later than 30 days after monitoring visit.
    - Servicing Letter #2 - Sent sometime after 15 days of sending Servicing Letter #1 if borrower fails to respond to Letter #1.
    - Servicing Letter #3 - Sent at least 60 days after date of first letter and at least 15 days after Letter #2.
    - Be sure to address ALL items of compliance in all of the servicing letters. Also make certain all servicing letters are tracked in servicing efforts in MFIS.

3. Evaluating the Borrower and the Project -
    - Evaluate whether it is in the Agency's best interest to attempt to work with the borrower to preserve the subject project.
    - Use procedures outlined in HB-3-3560 Chapter 6, Determination of Project Suitability.
    - Evaluation should come before any meeting with the borrower so Loan Servicer is familiar with the project and its status.

4. Meet with the Borrower - Establish a workout agreement according to Section 3 of HB-3-3560 and 7 CFR section 3560.453. The Agency is under no obligation to offer or agree to any special servicing action under 7 CFR section 3560.454. Special servicing actions may be implemented either as part of a workout agreement, or as an action approved by the Agency separate from a workout agreement unless indicated otherwise in 7 CFR part 3560.

5. Selecting Servicing Options (Tools)
    - Poor Management and Noncompliance with Program Requirements, see 7 CFR section 3560.102.
        - Borrower training
        - New management
        - Improving maintenance

        - Improving budget and record keeping, and using monthly reports
        - Improving outreach and marketing
- Acceptable Management, but Marketability and Cash Flow Problems
    - Upgrading project desirability
    - Reducing expenditures
    - Temporarily reducing or deferring reserve contribution levels
    - Increasing revenues
    - If the agency determines that a housing project with high vacancies could be kept operational and financially viable by increasing the amount of RA, the agency may do so, subject to the availability of funds to prevent or correct a compliance violation.
- Acceptable Management, but Lack of Project Demand
    - Granting occupancy waivers, see 7 CFR section 3560.454(b).
    - Changing the project designation (from elderly to family housing), see Section 4 of HB-3-3560, Chapter 10.
    - Implementing Special Note Rents, see 7 CFR section 3560.454(d).

6. Problem Case report
    - Use Form RD 3560-56, "*Report on Real Estate Problem Case*" (Use RD Instruction 1955-2, until the 3560 form is released)
    - This form describes the situation to the State Director and recommends enforcement action
    - State Director will review and respond within 30 days
        - Agreement with proposal for enforcement or
        - Directive for alternative servicing

7. Enforcement Actions - If the borrower fails to provide an acceptable workout agreement or fails to comply with the workout agreement, the Agency will initiate appropriate enforcement actions when liquidation is not in the Government's or tenant's best interest. Actions could include:
    - Termination of the management agreement, see 7 CFR section 3560.454(e)
    - Receivership; consult with OGC
    - Suing for performance under the loan document, see 7 CFR section 3560.456(a)
    - Collection of unauthorized assistance, see 7 CFR part 3560, subpart O
    - Referral to the Office of the Inspector General

8. Liquidation
    - Voluntary Liquidation, see 7 CFR section 3560.456(c)
    - Foreclosure, see 7 CFR section 3560.456(d)

<u>Step 5: Send series of servicing letters in accordance with handbook requirements</u>

HB-3-3560 includes the required series of Servicing Letters. It is important to adhere to the timeframes and process identified in the handbook at paragraph 10.10 and Exhibit 10-2 to ensure that proper notice is provided to the borrower. The Servicing Letters should be comprehensive and address all open findings so that the borrower knows with certainty the items that must be resolved.

IMPORTANT POINTS TO REMEMBER

- Provide preliminary notification to the borrower before starting servicing letters
- Be sure servicing letters are comprehensive
- Adhere to timing of servicing letters
- The National Appeals Division has found the Agency in error if notices are not in accordance with handbook
- Meet with the borrower to develop a workout plan that addresses ALL issues
- Consider any creative servicing actions that may not appear in the handbook; discuss these with the National Office

Step 6: Meet with Borrower

It is important to maintain clear communication with the borrower throughout this process as he tries to address project problems. Meet with the borrower and work with him to develop a workout plan to resolve all open issues. If an acceptable workout plan is developed, be sure to update MFIS, which will change the project classification to a "B".

Step 7: Develop acceptable, comprehensive workout plan in 60 days of meeting with the Borrower

Remember that it is not the Servicing Official's responsibility to develop the workout plan; borrowers who are not able to suggest appropriate resolution to project problems should be advised of the Agency's intended action. Note that 3560.453(b) states: The Agency is under no obligation to approve a workout agreement as submitted by a borrower or to act with forbearance when a housing project is in monetary or non-monetary default. In addition, HB-3-3560, Chapter 10, Section 10.23 says: Approval of a workout agreement is not guaranteed to a borrower. Failure to approve a workout agreement is not an adverse action by the Agency because the Agency is not required to grant approval of modifications to the terms of the loan for borrowers in default; thus, the Agency is not taking away any borrower rights by not approving the workout agreement. Therefore, failure to approve a workout agreement is not appealable by a borrower, although the Agency's decision may be reviewed.

The Agency has several options to offer a borrower in developing resolutions to project problems and these are outlined in HB-3-3560 and 7 CFR part 3560. A borrower's failure to utilize the assistance offered by the Agency should not result in a property remaining indefinitely in the "D" classification. Prompt action is necessary to enforce compliance.

Step 8: If no action, prepare Problem Case Report in accordance with handbook requirements

If the borrower cannot present an acceptable, comprehensive workout plan in 60 days, immediately begin preparation of the Report on Multi-Family Housing Problem Case and follow the procedures set forth at HB-3-3560, Chapter 10, paragraph 10-14.

Step 9: Accelerate account

In conjunction with your regional Office of General Counsel, issue the acceleration letter. Follow the guidance in HB-3-3560, Chapter 12 on Account Liquidation. As a note, compromise offers should only be offered after acceleration of the account.

Follow the guidance in the Rural Development Voucher Guidebook to order the Rent Comparability Study (RCS) in order to determine the amount of any vouchers that may be needed. If accepting a deed-in-lieu or payoff of accelerated account, order RCS immediately. Otherwise, follow foreclosure guidance.

Transfer of Rental Assistance from Certain Properties Not Permitted

As a result of these servicing efforts, MFH expects to recover RA from these "D" properties that result in acceleration. Recapturing RA will reduce the budgetary expense of the program.

The transfer of RA from all properties classified as "D" and the transfer of RA from all properties where the mortgage is paid off before the natural maturity date will not be permitted without the approval of the National Office. Both of these are subject to 7 CFR Section 3560.259(c), which gives the tenant the ability to move to another Rural Development property and take their RA with them for up to 4 months in prepayment, disaster, and foreclosure situations. It is the intent of the National Office to retire recaptured RA units.

The Rural Development Voucher Program is available to assist all low-income residents of Section 515 properties that are ultimately removed from the portfolio through foreclosure or prepayment, whether or not the tenants were receiving RA.

If you have any questions about this matter, please contact Stephanie White, Director of the MFH Portfolio Management Division, at 202-720-1615.