Section 542
FHA Risk Sharing Programs

CDBA Peer Forum Panel
May 27, 2015

Risk Sharing Program Overview

Background: Section 542 of the Housing and Community Development Act of 1992 established the two pilot risk sharing programs:

1. 542(b) Qualified Participating Entity (QPE) Risk Sharing Program

2. 542(c) Housing Finance Agency (HFA) Risk Sharing Program

Section 235 of HUD's FY 2001 Appropriations Act, Public Law 106-377, converted the pilot program into a permanent multifamily insurance program. Unit allocations and reservation of credit subsidy are no longer in effect.

Traditional FHA Programs vs. Risk Sharing

The Risk Sharing program differs from FHA's traditional mortgage insurance programs in that in the Risk Sharing programs:

- FHA assumes only a portion of risk, rather than all;
- FHA delegates loan processing and asset management functions to the HFA or QPE;
- FHA has more stringent eligibility standards for lender participation and sets larger reserve requirements that reduce counterparty risk.

Section 542 Program Requirements

- The Risk Sharing Program is entirely affordable production.

- All projects insured under the Risk Sharing Program must qualify as affordable housing as defined in the LIHTC Program:
  - 20 percent or more of units occupied by families whose income is 50 percent or less of the area median income; or
  - 40 percent (25 percent in New York City) or more of units are occupied by families whose income is 60 percent or less of the area median income.

542(c) HFA Risk Sharing Program

Provides credit enhancement to state and local housing finance agencies' (HFA) bond and debt issuances through FHA mortgage insurance.

- Currently 35 HFAs participate in the 542(c) Program.
- The HFA and HUD share risk on a transaction level. Underwriting and asset management responsibilities are delegated to the HFA.
- HFA benefits: higher bond ratings resulting in lower borrowing costs and savings passed on to borrowers and tenants.
- HUD benefits: reduced risk at the transaction level, increased affordable housing production and significantly reduced staff resources.

542(c) HFA Risk Sharing - How the Program Works

- Qualified HFAs authorized to underwrite, process, and service loans, and to manage and dispose of properties.
- HFAs enter into Risk Sharing Agreements with HUD; HFA contracts to reimburse HUD for a portion of loss on any claims.
- HFAs approved at the following risk level percentages:
  - Level I – 50/50 shared risk: HFA uses it own underwriting standards; or
  - Level II – 90/10 or 75/25 shared risk – HFA uses underwriting standards, loan terms, and conditions approved by HUD; or
  - Combined levels of I & II – HFA approved to use both levels.

Approximately 2/3 of portfolio are Level I transactions and 1/3 are Level II. Claim rates do not vary significantly between Level I and Level II.

- Over the life of the program no HFA has failed to meet its reimbursement obligation.
- There have been 38 claims on over 1000 transactions.

542(c) HFA Risk Sharing Performance

The Risk Sharing program performance compares favorably with overall performance of all FHA Multifamily Programs for the period FY 2011-FY 2013. Performance in this period supports the value of the risk sharing approach with its reliance on delegated decision-making based on shared risk.

Fiscal Year	**Active Loans** Beginning of Year		**Full Claims**				
			Counts		Dollars		
	Count	UPB (millions)	Count	Rate	Total (millions)	Rate	Average (millions)
			All FHA Multifamily Programs				
2011	9,966	$45,489	51	0.23%	$159	0.35%	$ 7
2012	10,221	$51,498	19	0.19%	$189	0.37%	$10
2013	10,556	$60,113	11	0.11%	$ 94	0.16%	$ 9
			Section 542(c) HFA Performance				
2011	962	$4,979	1	0.10%	$1	0.02%	$1
2012	1012	$5,249	0	0.00%	$0	0%	$0
2013	1038	$5,410	1	0.10%	$0.55	0.01%	$1

542(b) QPE Risk Sharing Program

- Current QPE participants are Fannie Mae and Freddie Mac.

- Provides reinsurance as a form of credit enhancement. The reinsurance occurs after the original financing as taken place.

- Similar to mortgage insurance it reduces the GSE risk exposure by committing federal government to pay portion of any losses.

542(b) QPE Risk Sharing Program Accomplishments

HFA	# of loans endorsed	$ amount of endorsements
Fannie Mae	198	$831 million
Freddie Mac	138	$1.00 billion
NYCHDC (FFB)	1	$72 million

FISCAL YEAR	# of loans endorsed	$ amount of endorsements
2011	22	$189 million
2012	41	$453 million
2013	40	$312 million
2014	14	$306 million

542(b) QPE Risk Sharing Program
How the Program Works

- The QPE assumes all up front costs relating to the mortgage loan and any risks related to construction;
- HUD does not reinsure construction loans;
- HUD does not reinsure the mortgage loan until project has been completed and is at least 50% occupied. QPE establishes and is solely responsible for the application, origination, servicing, delinquency resolution, and loan disposition standards in accordance with Risk Sharing Agreement;
- QPE is required to notify HUD of any changes to its standards and procedures.

542(b) QPE Green Risk Sharing Initiatives

- To preserve older affordable properties and encourage installation of energy-saving features, in 2011 Multifamily Housing created a version of the 542(b) Risk Sharing Program called Green Risk Sharing.

- In return for making units affordable and at least 5% of loan proceeds used for energy retrofits identified in a Green Needs Assessment, HUD and QPEs will share risk on loans that offer more favorable LTVs and Debt service coverage, but require higher MIP than traditional QPE 542(b) loans.

542(b) Small Buildings Risk Sharing Initiative (SBRS)

OBJECTIVES:

- Increase the supply and preservation of affordable small properties. Small properties face significant obstacles accessing fixed rate, long term financing.

- Attract new lenders to this underserved segment of the market with inclusion of high capacity CDFIs, or non-profit, or public or quasi-public agencies (Mission-Based Lenders).

542(b) Small Buildings Risk Sharing Initiative (SBRS)

OBJECTIVES (continued):

- Support affordable housing while minimizing risk to FHA Insurance Fund (under MAP loans, FHA assumes 100% of claim/insurance risk; under Risk Sharing loans, FHA assumes 50% of the claim/insurance risk).

- Utilize existing Risk Sharing program platform that allows delegated processing, decision making, and closing procedures to enhance the delivery of affordable housing in local markets.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Program Overview

- Lenders share risk 50/50 with HUD

- Projects must qualify as affordable housing, consistent with Section 42 LIHTC Program: 20% of the units restricted to households at 50% AMI, or 40% of the units restricted to households at 60% AMI.

- Eligible properties are 5 -49 units

- Loan amounts are limited to $3,000,000.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Program Overview (continued)

- Lender’s first year in the program: limited to 20 loans or $50 million in closed loans.
- SBRS is a preservation initiative: new construction is not permitted. Substantial rehabilitation and refinance only.
- Loans may be ‘insured upon completion’ or ‘insured advances’.
- MIP will be published in the Federal Register.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Program Overview (continued):

- Lenders (QPEs) use their own underwriting standards, loan terms and conditions; asset management and servicing policies as disclosed and approved by HUD in its application to the Risk Sharing Program.

- Project applications for firm approval are processed in HUD's Regional/Satellite office in the geographical area where the property is located.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Program Overview (continued):

- Property management and servicing is the responsibility of the lender.

- In the event of a claim, HUD pays 100% of the unpaid principal balance upfront. The lender issues a 5-year debenture to HUD, and has up to 5 years to reach final settlement and share 50/50 in the profit or loss with HUD.

- Compliance with Davis Bacon is not required for 542b.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Application Requirements

Two stage process for lender applications to participate in SBRS:

Pre-Qualification and Final Application

Pre-Qualification stage:

- Applicant demonstrates it meets organizational requirements for “Mission Based Lenders”
  - Certified as a CDFI by the CDFI Fund or
  - Mission based: non-profit, quasi –public, or public agency
- Lending experience for production and preservation of affordable multifamily housing.
- Certifications of compliance with Fair Housing and Civil Rights requirements.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Application Requirements (continued)

Pre-Qualification Stage (continued)

Financial Capacity Standards

- Minimum net asset ratio of 20%;
- Net income from best 3 of past 5 years;
- Minimum loan loss reserve ratio of 30%;
- Operating liquidity of 1.0 for previous 2 years.

Pre-Qualification lender applications will be reviewed in approximately 30 days.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Application Requirements (continued)

Final Application Stage

Must be submitted no later than 90 days after lender is notified of pre-qualification approval. Applications will include (in part*):

- Approval as FHA non-supervised mortgagees;
- Narrative with organizational history, mission, demonstrable multifamily affordable lending experience, technical capacity, mortgage credit, underwriting, servicing and monitoring procedures;
- Environmental: projects must comply with requirements of 24 CFR Part 50; describe experience with environmental review process;
- Appraisal functions: completed by Certified General Appraisal in accordance with USPAP;
- 3 years audited financial statements.

***Complete details will be on HUD's website with a link in the Final Notice.**

542(b) Small Buildings Risk Sharing Initiative (SBRS) Proposed Significant Changes since 2013 Initial Notice:

- **Pool of eligible lenders will be expanded**, from the original "CDFIs, Nonprofit, Public, or Quasi-Public loan funds with affordable housing purposes" to include FHA MAP-qualified lenders, applications accepted 6 months after program opens;
- **Added a $50MM/20 Loan Limit per lender for year 1**; upon evaluation of the program and assessment of risk, HUD may remove this limit;
- **Equity Take-Outs or "cash out" are permitted**, but cannot exceed the scope of work paid for from the Risk Sharing loan. All capital needs in Capital Needs Assessment (CNA) must be addressed either through scope of work and/or adequate reserves for the life of the loan.

542(b) Small Buildings Risk Sharing Initiative (SBRS) Proposed Changes since 2013 Initial Notice (continued):

- **Loan amount is limited to $3 million,** or $5 million in high cost areas as designated by HUD.
- **Eligible projects must consist of 5 or more units.** In the Initial Notice, eligible projects were either 5-49 units (no loan size limit), or for projects with more than 49 units, the loan amount could not exceed $3 million.
- **Minimum financial capacity requirements** added.

Target date to publish is June 2015. Complete information for “Application Requirements” and “Program Details” will be posted on HUD’s Multifamily website with the link in the Final Notice.