Multifamily Mortgage Business Lender Letter 12-09

October 25, 2012

To: Chief Underwriters

From: Rob Levin, Vice President for Multifamily Credit, Underwriting

Subject: Lender Letter 12-09 | Best Practice for Analyzing Refinance Risk

HIGHLIGHTS

- Fannie Mae announces a best practice for analyzing refinance risk.

Note: This letter is for informational purposes only - no action is required. Capitalized terms not otherwise defined in this Lender Letter have the meanings set forth in the Multifamily Selling and Servicing Guide.

Introduction

Section 312 of Part IIIA of the Guide requires Lenders to analyze the refinance risk of Mortgage Loans intended to be sold to Fannie Mae. In most cases, a combination of amortization and growth of Net Operating Income (NOI) should result in a conventional refinancing at the minimum Debt Service Coverage Ratio and maximum Loan-to-Value for Tier 2, at a reasonable interest rate. However, in order to ensure consistency and maintain quality, we are providing additional guidance to Lenders, in the form of a best practice, that we believe results in a refinance risk or exit analysis that (1) yields a prudent estimate of the NOI at a Property over the term of the Mortgage Loan and (2) accurately assesses the feasibility of a conventional refinancing at maturity. In all events, Fannie Mae expects that Lenders will continue to prudently exercise their underwriting judgment when analyzing refinance or exit risk with respect to any Mortgage Loan.

Best Practice – Refinance Risk Analysis

Base Assumptions

We have set forth below a set of assumptions that should form the basis or foundation of an appropriate exit analysis. These assumptions have been derived from an analysis of historical trends and are most relevant to Properties in competitive and open sale markets that are operating at normalized expense loads and economic vacancy levels. As such, these assumptions are just baseline thresholds and indicative only. If individual circumstances and facts affecting a Mortgage Loan or a Property support the use of more conservative estimates, Lender should utilize the latter.
• NOI: Underwritten NOI should equal Year 1 NOI.
• Income Growth Rate: 2%.
• Economic Vacancy: Underwritten economic vacancy held level for the Mortgage Loan term.
• Expense Growth Rate: 3% (property taxes in California may be trended at 2%).
• “Reversion” Cap Rate: Capitalization Rate used for determining Underwriting Value, plus 2.0%.
• Refinance Interest Rate: The current 10-year Fully Amortizing Nationwide Underwriting Floor rate for Tier 2, plus 2.25%.
• Amortization: The shorter of 30 years or the amortization requirement for the applicable asset class or loan or product type, considering the age of the Property in all events.
• DSCR: The higher of 1.25x or the minimum DSCR for the applicable asset class or loan or product type.
• LTV: The lower of 80% or the maximum LTV for the applicable asset class or loan or product type.

Deviations from Base Assumptions

If Lender determines that the assumptions set forth above do not represent an appropriate estimate of NOI for the Property over the term of the Mortgage Loan, Lender should complete an alternative analysis using assumptions that deviate from those set forth above, while still considering the following:

• Income/Expense Growth: Trending of income and expense should take into account projected market rates based upon general economic conditions and market and submarket conditions. Specific documentation from reliable sources must support the assumptions utilized. Rent projections greater than 2% generally should not be utilized after Year 4. Rents on recently signed leases should only be used for estimating income growth in Years 1 and 2.

• Economic Occupancy: Properties in submarkets that are experiencing depressed economic occupancy due to temporary demand or supply issues may be modeled to reflect expected economic occupancy, however, any increases should appropriately reflect the expected timing to achieve stabilized levels (and the stabilization occupancy level should reflect historical levels). The effect of increasing economic occupancy on projected income growth over the same period should also be considered.

• “Reversion” Cap Rate: An appropriate reversion Capitalization Rate may be utilized if it reflects the impact of the term of the Mortgage Loan and historical capitalization rates for comparable Properties in the submarket.
Examples of where deviations would be appropriate to more accurately estimate NOI include:

- **Income Growth:** When improvements in market economic occupancy or sustained market rental rate increases are widely anticipated.

- **Property Taxes:** When a Property is subject to a scheduled reassessment or a phase-in of taxes due to a prior abatement.

- **Commercial Space:** When tenant improvement allowances and leasing commissions are expected to be incurred or increase as a result of expected rollover of commercial tenants.

Deviations should be identified and discussed in the Transaction Approval Memo and supported by specific, reliable evidence and historical and projected market trends. Conclusions and any risk mitigants should also be discussed. Risk mitigants may include the strength of the sponsor or the submarket or the Property’s characteristics or operating history and performance.

**Questions**

Please contact your Fannie Mae Deal Team.