MassHousing Rental Lending
Capital Needs and Replacement Reserve Policy

Issuing Department	**Rental Underwriting**
Effective Date	**December 1, 2017**
Expiration (if any)	**Until Superseded**
Policy Owner(s)	**Director of Rental Underwriting**
Policy Contact(s)	**Director and Managers of Rental Underwriting**

I. **Policy** | In underwriting all financing transactions, MassHousing will evaluate the future capital replacements based on useful life expectations to reasonably determine that the property's resources will be adequate to meet the property's physical needs over the term of the MassHousing loan.

II. **Applicability** | This policy governs the underwriting of all permanent multifamily loan transactions to be financed under the following programs: MassHousing's HUD/HFA Risk Sharing Program (including FFB); and permanent, amortizing loans made from MassHousing's working capital funds. This policy does not apply to the following types of multifamily loan transactions; (a) Loans made under FHA Multifamily Accelerated Processing (MAP) programs (which are governed by HUD's program requirements); (b) conduit loans made by third party lenders; (c) construction or bridge loans; and (d) non-amortizing subordinate loans.

III. **Procedure Sections** | The following procedures will be followed to determine the appropriate funding for a property's long-term capital needs during the life of the new MassHousing permanent loan.

(A) **<u>Preservation of Existing Developments</u>**

1. **Borrower's Proposed Scope of Work.** Together with the One-Stop Application for financing commitment, the borrower will be asked to submit a clear and concrete scope of work to be undertaken within a certain time frame (generally, 9-24 months) following transfer or refinancing of the property. This proposed rehabilitation scope may be articulated by way of architectural plans, narrative description or other means, but must be based on an informed and systematic evaluation of the property's current physical conditions, e.g. through a capital needs analysis, or architect's or engineer's survey of exiting building conditions.

The borrower's proposed initial scope of work should generally incorporate rehabilitation related to building code and life safety requirements, mechanical systems, energy efficiency measures, and handicapped accessibility requirements. Cosmetic repairs and upgrades, such as the replacement of functional kitchen cabinets, may be incorporated as part of initial work scope, or may be planned for future improvement to be funded from replacement reserves.

2. **Capital Needs Analysis.** Upon receipt of the One-Stop Application and proposed scope of work, the Agency will commission an independent capital needs analysis which assumes, as a baseline scenario, that the borrower's scope of work will be completed during the intended time frame. (Under certain circumstances, at the discretion of the Director of Rental Underwriting, the capital needs analysis may be commissioned prior to the borrower's submission of the One-Stop Application and defined scope of work.) Once the borrower defines their scope of work, it will be integrated into the final capital needs analysis report.

   The capital needs study will also forecast over a 20-year period future capital replacement needs based on useful life expectations by system (including quantities and costs) and assuming continued effective maintenance and physical management of the property. The study will estimate the dollar amount of replacement reserves required to undertake capital replacements each year during this 20-year period, employing the following:

   (a) **Sizing of Initial Deposit to Replacement Reserve (IDRR).** A replacement reserve account will be established and capitalized at the closing of the MassHousing loan in an amount set by the Agency based on factors including the nature of the physical asset and the ability of the development's net operating income to absorb future increases in replacement reserve deposits.

   (b) **Sizing of Annual Deposit to the Replacement Reserve (ADRR).** The capital needs consultant will calculate the appropriate level of ADRR required to fully-fund all projected repairs and replacements for the first 10 years of the assessment period. The minimum Year 1 ADRR for an existing development will generally be set at least at $500/unit.

   (c) **Other Assumptions.** In addition, the preparer of the capital needs study will use the following assumptions:

(i) The minimum projected year-end escrow balance for years 1-10 will be set at 10% of the total uninflated needs for the first decade;

(ii) The targeted projected year-end escrow balance for years 11-20 will be set at 5% of the total uninflated needs for the first and second decade; however

(iii) Negative year-end balances in years 11-20 are acceptable so long as they do not exceed 50% of the amortized loan principal in any given year. Fully-funding all projected repairs and replacements for the second decade of the assessment period may not be required.

(d) **Loan to Value Ratio.** The maximum loan to value ratio for most loans subject to this policy shall be 90%. However, for refinancing transactions that involve an equity take-out by the owner, the maximum loan-to-value ratio will be 85%, to increase the likelihood that cash flow will be available to fund capital needs of the property over the life of the loan. Additionally, the Initial Deposit to Replacement Reserves (IDRR) required at loan closing may be greater than the minimum $500/unit in 2(a) above based upon Agency staff's analysis of projected development cash flows over the 20-year period.

(e) An independent, Agency-commissioned capital needs assessment paid for from the development's replacement reserve escrow account will be required by year 10 (or sooner at staff discretion) which will serve (if necessary) to reset replacement reserve deposits for at least the subsequent 10 years and up to 20 years, based upon the projected needs of the development.

(B) **Special Provisions for New Construction or Adaptive Reuse Developments**
In addition to the terms outlined above, new construction and adaptive reuse developments will be subject to the following:

1. The minimum Year 1 ADRR for a New Construction Development will generally be set at least at $360/unit. The minimum Year 1 ADRR for an Adaptive Reuse development will generally be set at least at $425/unit.

2. For New Construction and Adaptive Reuse transactions, MassHousing may conduct internally or order an independent capital needs assessment to establish the ADRR and/or IDRR necessary to meet the requirements described above.

IV. **Roles and Responsibilities** | The underwriting process described in this policy shall be carried out and or directed by the underwriter or underwriting manager assigned to a transaction by the Director of Rental Underwriting or his/her designee. Underwriting managers are responsible for ensuring compliance with this policy and evaluating whether exceptions to this policy should be made. Any such exceptions must be approved by the Director of Rental Underwriting and clearly identified in the loan proposal presented to staff and to MassHousing's Board Loan Committee.

The Director of Rental Underwriting shall be responsible for ensuring the accuracy of this policy and the consistency of underwriting practices with the policy. Amendments to this policy may be proposed by the Director of Rental Underwriting following input from all affected parties, subject to approval by the Deputy Director and/or Executive Director.