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Charting a Course Through a New Multifamily Lending Landscape

Investors need to plan ahead for the third-party due diligence requirements of lenders. Some of these requirements have changed.

By Summer Gell, Partner Engineering and Science Inc.

Multifamily housing investors' options for financing sources have been shifting lately, and Fannie Mae's recent major revisions to the Multifamily Selling and Servicing Guide–which went into effect in February 2014–are adding another layer of complexity to the multifamily lending landscape.

Fannie Mae's Guide revisions included underwriting standard changes in addition to significant changes to the third-party engineering due diligence required for multifamily mortgage loans, more specifically the policies for Physical Needs Assessments (PNA, also called a Property Condition Assessment by other lenders) and Seismic Risk Assessments (SRA) for properties in high risk seismic areas.

These assessments are common due diligence tools used by lenders, investors and other parties in a transaction to understand how the physical condition of the property and building systems will impact the asset's financial performance, including the cost of maintaining the property over time and its performance during a seismic event.

The Guide revisions-which impacted many aspects of the PNA process including consultant qualifications, the scope of work and report format–amounted to one of the more substantial overhauls of policies that the industry has seen lately.

Yet Fannie Mae isn't the only one shaking things up in recent years. Freddie Mac also announced policy updates in 2013 including tighter enforcement of its qualification requirements for third-party providers and a revised seismic risk policy. Adding to these shake ups are the broader dynamics of Fannie Mae and Freddie Mac pulling back in their lending while CMBS, life insurance lenders and other are stepping in to fill in the void.

With all these changes afoot in the lending landscape, many multifamily investors are taking a step back, re-examining their options and assessing what will be the best fit for their deal. An important part of that consideration is the third-party due diligence required for multifamily mortgage loans and their potential impacts on cost, scope of work and timing. Investors should understand the recent due diligence changes of Fannie Mae and Freddie Mac, and how they compare to due diligence requirements for other multifamily financing sources, in order to navigate their options.

Fannie Mae's PNA Revisions
As noted, Fannie's recent Guide revisions were broad and made the Physical Needs Assessment more stringent or unique in several respects. Below are some of the more significant changes.

Qualifications (PNA): Fannie Mae now has detailed the requirements for who is qualified to conduct Physical Needs Assessments, which are above industry norms. Their requirements–which are a combination of minimum education, experience, professional certifications, registrations and/or training–are spelled out in three sets of criteria for: 1) the engineering firm; 2) the individual field assessor; and 3) the report reviewer. Perhaps what set these criteria apart the most are the training requirements. There is some concern in the industry that the pool of qualified consultants would now be reduced to the point of affecting the report cost and turnaround time.

Estimated Useful Life: Estimated useful life (EUL) is an estimate of the expected lifespan of a building system before it will need replacement. Fannie now dictates what the EULs should be for the various building systems, rather than deferring to the consultant to use industry standard EULs. There is some concern that this will result in higher per-unit reserve costs due to a few cases where Fannie's prescribed EULs are shorter than industry norms (meaning replacement will be needed sooner), but we don't anticipate the increase to be significant based on our internal evaluation.

Unit Observations (PNA): Fannie's requirements for the number of units to be observed during the site visit go above industry norm of 10% in most cases, the kicker being that all units vacant for longer than 90 days and all down units must be observed. The consultant must choose the units rather than the on-site personnel (to avoid only being shown the "good" units); this requires additional planning before the site visit.

Report Modules: Fannie is now also prescribing the use of different report modules which will determine additional items to be assessed (above Fannie's base PNA report module) based on specific property types (for ex., student housing) or loan types (for ex., the Green Refinance Plus Program). This is a unique requirement to Fannie.

Seismic Risk: Fannie's seismic risk requirements have also changed slightly with their recent guidelines. To date, the generally accepted standard for screening whether a property is located in a high-risk seismic area (and therefore might require a Seismic Risk Assessment) has been for the lender to reference a map of seismic zones to see if the subject property fell into a high risk zone (zones 3 and 4). Now, Fannie requires a more sophisticated seismic hazard search method. Fannie lenders must now perform a site-specific search of the subject property's seismic hazard based on the "peak ground acceleration" or "PGA." Peak ground acceleration is a term that correlates to the maximum shaking hazard a site is likely to experience during an earthquake of a specified return period (or frequency of occurrence e.g every 475 years, similar to a 100-year flood). The PGA determination is rather simple and you only need to worry about one number: If the PGA is equal to or greater than 0.15g for a 475-year earthquake (referred to by Fannie as the 10% in 50-year earthquake, which is the same thing), and certain risk factors are present at the property or if the mortgage loan is greater than $25 million, an ASTM E2026/E2557 Level 1 Seismic Risk Assessment would be required.

Freddie Mac's Policy Updates

Freddie Mac's policy announcements in the last year included a stricter enforcement of their qualification requirements that were already in place, as well as a revised seismic risk policy.

Qualifications (environmental): Freddie Mac's requirements for who is qualified to conduct the Phase I Environmental Site Assessments also exceed industry norms. Most notably, the person conducting the site visit must have a minimum of three years of experience and asbestos inspection training.

Qualifications (property condition): Freddie Mac also has stringent qualification requirements for those conducting Property Condition Assessments–most notably a degree in engineering and/or architecture and a minimum of five years relevant experience. When the tighter enforcement was announced, there was a similar concern about limiting the pool of consultants and ensuing increases in report costs and time; however, this concern did not seem to materialize in a substantial way.

Seismic Risk: Last year's revisions to Freddie's seismic policy weren't drastic and for the most part made Freddie's requirement more consistent with industry standard practice; however, there are a several noteworthy highlights:

Screening: Freddie still requires the use of the seismic hazard zone map for the initial screening and if the property is in a high risk area (zones 3 and 4), a Seismic Risk Assessment will be required.

Scope: The less expensive "desktop" or Level 0 Seismic Risk Assessment will continue to be used for properties in seismic zones 3 and 4, but the policy now requires the borrower to go straight to a Level 1 Seismic Risk Assessment if the asset also exhibits certain high risk characteristics identified by Freddie's Form 1105, "Multifamily Property Condition Form."
Qualifications (seismic): Freddie specifies a set of qualifications required for both the individual site assessor and the report reviewer, most notably that site assessor has an engineering or architectural degree and that the reviewer is a licensed engineer or architect in a seismically active state.

CMBS, Life Insurance and Commercial Banks
Third party due diligence for CMBS lenders, life insurance lenders and commercial banks typically follows the more industry standard EPA/ASTM scopes of work and qualification requirements. Many of these lending institutions have their own scope of work according to internal risk management policies and these can vary significantly, from requiring less than ASTM and industry standard to much more comprehensive scopes.

HUD
HUD mortgage loans and their required due diligence process are so unique that there are a limited number of lenders that are certified to underwrite HUD loans, and many multifamily investors plan for the project to be a HUD project right from the start. If the loan won't work for HUD, the borrower may go another agency route, but don't often see it work in the reverse order unless the interest rates are favorable to HUD.

Not sure of the funding source?
Often, multifamily investors are ready to begin the due diligence process, but have not yet decided on a lender–whether Freddie, Fannie, CMBS or other. This is a really critical piece of information for a consultant to ask up front as the scope of work can vary significantly. In cases where the source of financing is in question, the best route is often the most comprehensive scope of work, using the most stringent personnel qualification criteria, to ensure additional costs and delays aren't incurred later when an assessor has to return to the site to meet additional scope or qualifications requirements. Yes, you run the risk of paying a little more for a scope you may not ultimately need, but it's usually less of a headache than fixing it after the fact.

After all the changes that have taken place over the last year or so, the more comprehensive course of action in many cases would be:

- Phase I Environmental Site Assessment to Freddie Mac's standards
- Physical Needs Assessment to Fannie Mae's standards
- Seismic Risk Assessment to Freddie Mac's standard
- Using consultants that are qualified based on Freddie Mac's requirements.

This won't always be a foolproof course of action depending on the situation and the consultants' qualifications, but if you can't wait to start the due diligence, it might be a good place to start.

There are many other nuances to consider between the various multifamily funding sources, their due diligence requirements and risk tolerances. When in doubt, a conversation with a knowledgeable consultant can help steer you in the right direction.

Fannie Mae has been open to feedback received from various stakeholders over the last few months about the impacts of the guideline updates, and has stated that they won't "price themselves out of the market." Early signs indicate that this won't be the case, but the exact impacts will become clearer over the next few months as the new requirements play out.

Summer Gell is principal and national client manager at Partner Engineering and Science Inc. Gell has more than 15 years of experience in the multifamily and commercial real estate due diligence field. As principal and national client manager at Partner, Gell has a deep understanding of the specific needs and scopes of work required for the different parties involved in the transaction.