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Views

Overhauling Fannie Mae's Physical Needs Assessment: What Lenders And Investors Need To Know

By Aaron Kovan

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Last fall, **Fannie Mae** announced a major revision was coming to its Multifamily Selling and Servicing Guide. Since then, lenders, investors and their consultants have been trying to wrap their heads around the changes and how they will affect business. The final guidelines have gone into effect as of Feb. 3, but there are still many questions that need to be answered.

In addition to underwriting standard changes, there were significant changes to the engineering due diligence requirements, namely the Physical Needs Assessment and seismic risk screening.

These assessments are common due diligence tools used by lenders, investors and other parties to understand how the condition of a building will impact the asset's financial performance. The Physical Needs Assessment (PNA) assesses the physical condition of a property and its systems, identifies significant deficiencies or risks and estimates the short and long term costs to maintain the property. The Seismic Risk Assessment is an evaluation of how well a building will perform during an earthquake.

Fannie Mae's scope of work for due diligence reports has always had nuanced differences compared to other lender's and agency's scopes of work, and now with these substantial PNA revisions we are fielding lots of questions from clients on their impacts and how to implement the new standard.

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>
> —Aaron Kovan, Partner Engineering and Science

Why the Changes?

One possible reason: to change with the times. Fannie Mae had not had major changes to the Multifamily Selling and Servicing Guide since 1992. Another possible reason: Fannie Mae may be trying to increase the quality of its overall portfolio, seeking a higher percentage of class A and B properties. Additionally, Fannie Mae is clearly making efforts to improve the quality and consistency of the Physical Needs Assessments reports and providers, as you'll see reflected below.

Major Changes

The revisions impacted many facets of the PNA process, from consultant qualifications, to the scope of work and report format. Below are highlights of the most significant changes.

Qualifications of Consultants

The previous requirements for consultants conducting a Physical Needs Assessment were rather undefined and flexible. This led to a number of consultants serving this space that perhaps were not well-qualified to do so. With this update, the qualifications criteria now clearly state the minimum education, experience, professional certifications, registrations and/or training required for the engineering firm, the individual field assessor, and the report reviewer.

These more restrictive requirements could eliminate some consultants from the pool of qualified vendors, especially smaller firms with fewer staff to draw from or less capital to cover training course costs. There has been some concern about limiting the pool of vendors; however, many of the larger and/or more established consultants will be able to adapt easily to these new requirements.

Lenders are responsible for maintaining a statement of qualifications of the engineering consultant and ensuring that the consultant maintains copies of all the required certifications and experience documentation for each report.

Reserve Costs

Fannie Mae now specifies the Estimated Useful Life (EUL) for various site improvements – this is an estimate of the expected lifespan for a building system before it will need replacement. Exterior paint, for example, typically has about an eight-year lifespan, so exterior paint that is two years old will likely have another six years before it needs repainting. These calculations are factored into the PNA cost tables.

That isn't such a big deal, right? Well actually, there has been a lot of concern over whether Fannie Mae's prescribed EULs differ from what the industry has typically used and whether those differences would drive up the per unit reserve costs.

Higher reserve amounts directly influence the underwriting for the lender and therefore the interest rates that they have to charge the borrowers. Some have been concerned that the reserve costs would now be so high that Fannie Mae loans won't be as competitive in the multifamily housing markets, but I don't believe this will be the case.

In a few cases, Fannie Mae's prescribed EULs are shorter than industry norms and therefore the reserve costs have ticked up slightly, but the vast majority of building system EULs are consistent with industry norms.

New Special Hazard Requirements – Earthquakes, Volcanoes, Floods, Oh My!

And that's just the short list. Fannie Mae is paying more attention to a variety of "special hazards such as earthquakes, volcanic activity, floods, hurricanes, tornados, wind, or wildfires. Most of these items aren't typically covered within engineering due diligence reports, but consultants are only required to note whether the site falls into one of these risk zones, not opine any further—seismic risk being the exception.

Seismic risk considerations are not new to Fannie Mae's policy and the Seismic Risk Assessment scope of work has not changed, but the screening process to determine whether a Seismic Risk Assessment is needed has changed.

Previously, the first step in screening required the lender to reference a map of seismic zones to see if the subject property fell into a high risk zone. Instead, Fannie Mae now requires a site-specific search of the subject property's seismic hazard based on its peak ground acceleration, or the most ground shaking a site is likely to experience during a specified earthquake. It is unclear whether more or fewer Seismic Risk Assessments will be required using this new screening method.

Report Format and Modules

The report format was previously left up to the consultant or lender to determine; Fannie Mae is now stipulating the structure of the report, which will make it easier for lenders to review reports from various consultants and may also help improve report quality. More significantly though, Fannie is now also prescribing the use of different report modules which will add items to be assessed based on specific property types (for ex., student housing) or loan types (for ex., the Green Refinance Plus Program).

The takeaway here is that lenders and consultants need to be aware of what modules will apply to the subject property at the outset of the project, so that additional time and/or costs aren't incurred to go back and revise the report.

Unit Observation Requirements

Consultants are now required to select the units to be observed during the site visit, rather than allowing the site contact to choose them. The intention is to get a more representative sampling of unit conditions by preventing preferential selection of the good units by the on-site personnel. A side effect of this requirement is that consultants have to receive more information up front to make the unit selections, such as current rent rolls and a completed 4099b pre-site visit questionnaire, rather than getting it during the site visit. With a bit more coordination on the front end, this change shouldn't impact the timing of reports.

Other Changes

Other changes include a new stipulation to assess the subject property's compliance with Federal Fair Housing Act (FFHA) accessibility requirements; remediation recommendations for certain problematic building materials; and an "informational only" seismic risk 4099c checklist (which does not impact whether a Seismic Risk Assessment is needed for the subject property).

Impacts for Lenders and Investors

In addition to the potential impacts discussed above, lenders and investors are wondering about the changes' cumulative effects on the three biggies—cost, schedule and quality.

Q: Will the cost of the reports increase?

A: It is possible; however, the cost of a report is dependent on several factors, such as property size, location, occupancy type, and client and agency reporting requirements. The new guidelines certainly are more restrictive than the previous version, but many of the larger and/or established consultants have already been writing their reports using internal policies close to those of the new guidelines.

The largest unknown factor will be the overall availability of qualified field assessors. Many bigger firms already have sufficient qualified staff to meet the new guidelines without much struggle and with minimal cost increases.

Q: Will report turnaround time increase?

A: There has been some concern that PNA turnaround time could increase due to the more restrictive qualification requirements and ensuing difficulty to staff a project. Again, the larger consulting firms will have a greater capacity to deal with these changes with minimal to no increase in schedule.

Q: Will report quality change?

A: On average across the industry, report quality will likely improve or a least be more consistent. Reports completed by many established Fannie Mae consultants won't exhibit a large increase in quality simply because their reports and internal policies already approximate the new reporting guidelines.

Multi-housing investors will now have to take these revisions into consideration when choosing whether to take their loan to Fannie Mae, **Freddie Mac**, CMBS or elsewhere.

Fannie Mae has been very open to feedback from all 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 answers to all these questions will become clearer over the next few months as the new requirements play out.