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23.1 Overview of Targeted Affordable Housing affordability components (12/16/15)

This chapter contains additional requirements for the following affordability components:

- Regulatory Agreements
- Section 8
- Section 236

23.2 General requirements for Regulatory Agreements (02/28/20)

Freddie Mac purchases or credit enhances Mortgages secured by Properties subject to Regulatory Agreements. The requirements of this section apply to any Mortgage that is subject to a Regulatory Agreement.

A Regulatory Agreement is a binding agreement that places income, rent or other use restrictions on all or selected units of a Property for a given period. A Property financed with tax-exempt bonds or eligible for LIHTC is or will be subject to a Regulatory Agreement. In addition, federal, State or local governments or their agencies may impose income or rent restrictions in connection with loans or grants to Properties, such as federal HOME loans or HUD Section 236 subsidies, or in connection with real estate tax abatements.

This Guide uses the term "Regulatory Agreement" generically. The term Regulatory Agreement also includes land use restriction agreements, declarations of restrictive covenants, extended use agreements and a variety of other agreements dependent upon the custom of the governmental entity imposing the restrictions.

a. Income restrictions (02/28/20)

A Regulatory Agreement may require that certain residents of a Property meet specific income eligibility requirements. Frequently, the income restrictions are based on a percentage of "area median gross income adjusted for family size" (AMI) that is published annually by HUD.

1. Tax-exempt bonds and LIHTC

   Properties financed through the issuance of tax-exempt bonds and LIHTC Properties have income restrictions established under the tax code. Freddie Mac reflects such restrictions in its underwriting.

   Freddie Mac will only purchase or credit enhance Mortgages secured by LIHTC Properties electing the Income Averaging Set-Aside if such election has been made in the tax credit application and the reservation letter (or the Internal Revenue Code (IRC) Section 42(m) letter, if applicable) and is reflected in the final IRS Form 8609(s), Low-Income Housing Credit Allocation and Certification. Additional underwriting and legal requirements for LIHTC Properties electing the Income Averaging Set-Aside are set forth in Chapter 55 and Section 6.4, respectively.

2. Other subsidies

Properties benefitting from governmental entity loans, grants, rental subsidies, or real estate tax abatements may also be governed by Regulatory Agreements imposing income eligibility conditions or limits. Freddie Mac reflects such conditions in its underwriting.

3. Multiple subsidies

If a Property receives multiple subsidies, it may be subject to multiple income restrictions imposed by different governmental entities. If multiple income restrictions result in income restrictions for units that overlap, Freddie Mac requires that the most stringent restrictions be followed, as in the example below:

A 60-unit LIHTC Property that is financed with a HOME loan and benefits from real estate tax abatement:

Governing Program	Income Restrictions
LIHTC	20 units at 30% AMI 40 units at 50% AMI
HOME loan	40 units at 30% AMI
Real estate tax abatement	All units at 50% AMI

In this example, the minimum income restriction requirement for the Property is 40 units at 30 percent of AMI and 20 units at 50 percent of AMI.

b. Rent restrictions (12/16/15)

Regulatory Agreements may include rent restrictions for income-eligible tenants. Freddie Mac reflects such restrictions in its underwriting. A Property receiving multiple subsidies may be subject to multiple rent restrictions imposed by different governmental entities. Freddie Mac requires that the most stringent restrictions be followed if multiple restrictions overlap.

c. Regulatory Agreement analysis (12/16/15)

The Seller's counsel must provide Freddie Mac with the Regulatory Agreement Analysis for each Regulatory Agreement to which a Property is subject.

d. Regulatory Agreement compliance monitoring (12/16/15)

The Servicer must comply with the requirements of Section 28.24 if a Property is financed by tax-exempt bonds.

23.3 Section 8 (02/16/23)

Freddie Mac purchases or credit enhances Mortgages secured by Properties receiving or expecting to receive rental subsidy payments through the Section 8 program. The nature of the Section 8 contract will determine the applicable underwriting requirements. Early in the underwriting process, the Seller/Servicer must inform Freddie Mac of the type of Section 8 contract on the Property, including any exception rent contracts. If the level of Section 8 subsidy is not material to a Property's income (for example, 20 percent or less of effective gross income (EGI)), Freddie Mac may consider the Mortgage to be a non-Section 8 Mortgage and will not underwrite the Mortgage using Section 8 criteria.

If a Property benefits from more than one type of subsidy, Freddie Mac requires the Mortgage to meet the underwriting requirements of each subsidy. Where underwriting requirements overlap, the Mortgage must be underwritten to comply with the most restrictive standard.

A Property may receive rental subsidy payments under a project-based contract or through tenant-based vouchers.

a. Section 8 project-based subsidy; definitions (09/26/19)

A Section 8 project-based subsidy refers to rental assistance associated with a specific Property rather than with specific tenants. The Property receives a cash payment based on the number of qualifying tenants living in qualifying units. The contractual basis for this form of subsidy is known as a Housing Assistance Payments (HAP) or a Section 8 contract. Freddie Mac classifies a HAP or Section 8 contract as either a Long Term Section 8 contract or a Short Term Section 8 contract.

A Section 8 contract is considered a Long Term Section 8 contract if:

- The term of the Mortgage is less than or equal to 20 years and the HAP or Section 8 contract is greater than or equal to the term of the Mortgage

- The term of the Mortgage is greater than 20 years and the HAP or Section 8 contract is greater than or equal to 20 years

All other HAP or Section 8 contracts are considered to be Short Term Section 8 contracts.

Other definitions pertinent to the Section 8 Program are as follows:

- Above Market, which refers to Section 8 rents that are higher than the achievable market rent, also referred to as "HAP Overhang"

- At or Below Market, which refers to Section 8 rents that are equal to or lower than the achievable market rent

b. Section 8 tenant-based subsidy; definitions (09/26/19)

This form of subsidy provides rental assistance to a specific tenant rather than a specific Property. The Property receives a cash payment based on the number of qualifying tenants. The written authorization provided to the tenant for this subsidy is known as a voucher.

See Section 23.3(e) for underwriting criteria for Properties with existing Section 8 voucher holders.

c. Section 8 income and expense requirements (12/15/20)

Freddie Mac underwrites to the lower of market rents, Section 8 contract rents, or LIHTC rents, where applicable, and with consideration given to whether there is a Long Term Section 8 contract or Short Term Section 8 contract in place.

1. Properties with Long Term Section 8 contracts

   For a Property with a Long Term Section 8 contract, Freddie Mac underwrites to the lower of HAP rent or market rent as follows: i) if the Property passes the refinance test at market rents, then Freddie Mac may underwrite the Mortgage with an Above Market HAP rent, up to 110 percent of market rents, without using the blended rate option described below, or ii) if the Property does not pass the refinance test at market rents regardless of the term of the loan, then Freddie Mac must underwrite the Mortgage using the bifurcation or blended rate option described below. If bifurcated, the real estate component must pass the refinance test at market rents. If the blended rate has been used, the full loan must pass the refinance test using the blended interest rate and blended amortization.

2. Properties with Short Term Section 8 contracts

   Freddie Mac will underwrite a Property with a Short Term Section 8 contract to the lowest of Section 8 contract rent, market rent or LIHTC rent, if applicable. However, If the HAP rent is Above Market, depending on the characteristics of the Mortgage, Freddie Mac may underwrite the rents with a HAP Overhang using the bifurcation option or blended rate option described below, and must pass the refinance test at market rents regardless of the term of the loan.

3. Maturity risk analysis

   If the Mortgage is underwritten with a HAP Overhang, then the Mortgage must pass a refinance test at market rent, regardless of the term of the Mortgage. In determining the achievable market rents, Freddie Mac reviews the market evidence and the appraiser's estimate of market rents to evaluate the rent levels achievable at the Property without a Section 8 contract.

4. Bifurcation option

   Requirements for the bifurcation option are as follows:

   - The real estate component (LIHTC or market) is underwritten by calculating the Property's net operating income (NOI) using the lower of LIHTC or market rents and expenses. Freddie Mac uses LIHTC rents when the unit is subject to rent restrictions and uses the market rents only when the unit is not subject to rent restrictions.

   - The HAP Overhang component must be sized to a DCR of 1.00x and structured so that it self-amortizes over the term of the Section 8 contract period or the term of the Freddie Mac Mortgage, whichever is less. The HAP Overhang component is underwritten using only the amount of additional income that the higher Section 8 contract rents would provide assuming the appropriate Section 8 vacancy. No expenses are deducted from the HAP Overhang income.

- Combined valuation: Freddie Mac bases the real estate value on the lower of market rents or tax credit rents, if applicable, and determines the additional value attributable to the excess Section 8 contract rents by using a discounted cash flow method at the Note rate.

- Freddie Mac determines the LTV by combining the real estate value and the excess rent value.

5. Blended rate option

   With the blended rate option, Freddie Mac underwrites the Mortgage using one note rate where the terms of the single note produce substantially the same blended UPB, interest rate and amortization schedule that would be produced using the bifurcation option described above. The UPB of the Mortgage at the end of the HAP contract must be no greater than 102 percent of the UPB had Freddie Mac used the bifurcation option.

6. Additional considerations

   Freddie Mac also considers:

   - Whether the Borrower Principal has both substantial net worth and experience in owning Section 8 properties

   - Whether the Property is located in a strong market with a low vacancy rate in subsidized units

d. Underwriting criteria for Section 8 vouchers (02/16/23)

If a Property has existing Section 8 voucher holders, Freddie Mac underwrites the Property to the lower of the voucher rent, LIHTC rent or market rent because of the tenant's ability to move from the Property.

For units that have voucher tenants covered under the Public Housing Authority (PHA) Project-based Assistance Program, if the voucher payment is At or Below Market rent, but higher than LIHTC rent, in certain circumstances such as high-cost markets, Freddie Mac may underwrite a percentage of the voucher payment that is above LIHTC rent, provided that the following conditions are met:

a. The voucher payment can be supported by either a PHA contract or rental history of the Property,

b. There is a demonstrated demand for Section 8 vouchers at the Property,

c. There is a substantial (more than 10 percent) affordability gap between the market rents and LIHTC rents,

d. A sensitivity analysis based on the LIHTC rents shows that the Property can maintain a minimum DCR of 1.10x,

e. The percentage, if any, must be determined by Freddie Mac at an early state in the transaction, and

f. The Property has a history of renting to tenants that hold vouchers.

e. Section 8 Replacement Reserves (12/16/15)

Freddie Mac requires the funding of a Replacement Reserve for each Property with a Section 8 contract.

See Section 39.6(f) for the Servicing requirements for a Replacement Reserve for a Mortgage with a term longer than 10 years.

f. Section 8 Transition Reserves (06/25/20)

Freddie Mac may require the funding of a Transition Reserve for a Property with a Section 8 contract.

1. Size

   The size of the Transition Reserve must equal or exceed six months of amortizing debt service, based on the proportion of project-based Section 8 units to the total number of rental units. Freddie Mac may require a higher Transition Reserve for a Property located in a weak market or if there are other underwriting concerns.

   If fewer than 20 percent of the Property's units are covered by the Section 8 contract, no Transition Reserve is required.

2. Funding

   A Transition Reserve is generally not required for a Long-Term Section 8 contract. The reserve will not be required when all of the following conditions have been met:

   - The Guarantor is acceptable to Freddie Mac.
   - The Borrower Principal owns at least five properties with Section 8 contracts, including the Property, and has at least 10 years' experience in affordable housing investment or development.
   - The Property is in satisfactory condition as determined by a property inspection conducted by Freddie Mac or the Servicer and has a REAC score greater than or equal to 70.

   A Transition Reserve is generally required for a Short-Term Section 8 contract.

3. Release scenarios

   Freddie Mac may release the Transition Reserve upon written request from the Borrower/Borrower Principal and satisfaction of at least one of the following two scenarios and the additional conditions set forth below:

Scenario 1 – all conditions must be met:

- The Section 8 contract has expired and will not be renewed.
- The Property, at market rents, achieves the current program minimum DSCR.
- The Property has already transitioned to operate as a nonsubsidized, market-rate rental Property.

Scenario 2 – all conditions must be met:

- The Borrower has secured a new fully executed Long Term Section 8 contract.
- The Property, with the new Long-Term Section 8 contract rents, achieves the current program minimum DSCR.

In addition, all of the following conditions must be met under either scenario:

- The Property has achieved 90 percent occupancy for a minimum of the 90 consecutive days prior to the written release request.
- There are no defaults.
- The Property is in satisfactory physical condition as determined by the most recent inspection conducted by either Freddie Mac or the Servicer.

g. Underwriting documentation for Section 8 (09/26/19)

The Seller must review the Section 8 contract documentation, including the rent, income and use restriction documentation (as applicable), specified in Section 55.2 and must submit it to Freddie Mac in the applicable underwriting package.

23.4 Section 236 (12/16/15)

This section provides the requirements for a Property benefiting from Section 236 interest subsidies, also referred to as Interest Reduction Payments (IRPs). For a Section 236 Mortgage to be eligible for sale to Freddie Mac, the Property must be currently receiving IRP assistance and must be in compliance with all applicable legislative and regulatory requirements.

a. Types of Section 236 interest subsidies (12/16/15)

Freddie Mac purchases or credit enhances both types of Section 236 interest subsidies:

- Section 236(b) Absorption

  An approved State or local lender purchases the insured Section 236 Mortgage, terminates the FHA Mortgage insurance, but keeps the Mortgage and IRP in place and provides additional financing if necessary.

- Section 236(e)(2) Decoupling

HUD permits the owner of a Section 236 Property to refinance a Section 236 Mortgage and retain the IRP subsidy, provided that the owner agrees to certain rent and income restrictions.

For both types of subsidies the owner must execute a use agreement with HUD that extends for at least five years beyond the term of the original Mortgage. In addition, the owner may not displace existing tenants. Tenants residing in Section 236 units must meet the Section 236 income limits. On the Origination Date of the Mortgage, the Property must be in compliance with all applicable legislative and regulatory requirements and must remain in compliance throughout the term of the Mortgage.

b. Basic Rent and Fair Market Rent (12/16/15)

Basic Rent is a HUD-calculated rent that is sufficient to cover the Property's operating expenses, debt service based on a reduced interest rate of one percent and a limited return on equity. Section 236 Fair Market Rent is a HUD-calculated rent that is sufficient to cover the Property's operating expenses, debt service payments based on the HUD note rate and a limited return on equity.

The Seller must submit to Freddie Mac in the applicable underwriting package evidence that HUD has approved the Basic Rent and Section 236 Fair Market Rent. Freddie Mac underwrites rents to the lowest of the Basic Rent, achievable market rent, or LIHTC rents, if applicable.

c. Mortgage structure and credit enhancement (12/16/15)

Freddie Mac underwrites the Mortgage for a Property with IRPs using a bifurcated structure – a real estate component and an IRP component.

Freddie Mac sizes the real estate portion of the Mortgage using the parameters applicable to each lending product.

Components	Minimum DCR	Maximum LTV
Real estate component	As applicable for each product	As applicable for each product
IRP assistance component	1.00x	100 percent of IRP value
Combined	N/A	N/A

IRP subsidy payments are made per a stated schedule and generally decline on a gradual basis over their term. The IRP component must self-liquidate over the term of the IRP subsidy. Freddie Mac may underwrite the IRP component to the annual IRP subsidy income for the term of the remaining IRP subsidy. Freddie Mac requires the Seller to prepare a cash flow analysis to show how debt service payments will be made; this cash flow analysis must be submitted to Freddie Mac with the underwriting package.

Freddie Mac calculates the IRP value discounting the IRP payment stream at the Note rate.

The Seller must prepare the refinance test available at https://mf.freddiemac.com/lenders/uw/refinance_test_template.html using the bifurcated structure and taking into consideration any impact the use agreement may have on future Net Operating Income (NOI).

The requirement to pass the Refinance Test does not apply to Mortgages with an amortizing Mortgage term of 15 years or more (for example, a 15-year Mortgage term with 30-year amortization).

If the Section 236 Property also benefits from a Section 8 subsidy, see the provisions for Section 8 in Section 23.3.