



NEW YORK STATE
DEPARTMENT *of*
FINANCIAL SERVICES

Andrew M. Cuomo
Governor

Benjamin M. Lawsky
Superintendent

TO: Banking Institutions Subject to New York State CRA Examinations
FROM: Benjamin M. Lawsky, Superintendent
DATE: September 5, 2013
RE: Guidelines for Bank Lending to Multifamily Properties Under the Community Reinvestment Act

The New York State Department of Financial Services (“DFS”) has received input from the public, private, and nonprofit sectors to the effect that the number of affordable multifamily properties considered in physical and/or financial distress has been rising in New York State. The reasons for this increased distress are complex, but it is clear that in the real estate boom preceding the financial crisis some investors purchased affordable multifamily properties using high amounts of debt financing in anticipation of increases in property values. When rental income did not cover the debt payments, some of those investors reduced building maintenance dramatically to cut costs. In other cases, investor-landlords searching for higher rental income displaced existing tenants. The financial crisis reduced investor interest in these highly leveraged affordable multifamily buildings for a time. Now, however, as the housing market recovers, investors are again interested in multifamily properties. And, again, some of these properties are highly leveraged investments. Unfortunately, indicators of distress previously witnessed during the real estate bubble are also beginning to rise.

Banks that have provided mortgages on these properties face difficult questions about how best to proceed, especially when required to foreclose by the failure of the owner to make mortgage payments and/or to maintain the property—the collateral on the loan. A bank holding a mortgage may seek to avoid losses through the sale of the mortgage note, usually to the highest bidder. While banks have a responsibility to maximize the return on their assets, and while these note sales may be profitable in the short term, if they involve high leverage, they can negatively affect the housing market, neighborhoods, and the value of a bank’s collateral. When price is the primary factor in selecting a buyer for the note, and the costs of addressing the physical condition of the property are not adequately considered, the sale can lead to a recurring cycle of default, deterioration, building code violations, foreclosure, and repeat sale—all of which has a ripple effect beyond the individual building and thus contributes to neighborhood decline

DFS must consider the integrity and viability of bank loan portfolios and the impact bank practices have on the communities in which they conduct business; otherwise, it would be remiss in its obligations under the State’s Community Reinvestment Act (Banking Law § 28-b (“CRA”).

DFS intends to address this serious public policy issue. A number of steps are under consideration, including revising the CRA examination guidelines and issuing best practice recommendations to banks. DFS looks forward to discussing these proposals with its fellow regulators, the banking industry, and community groups. Proposals under consideration include the following:

I. CRA Multifamily Community Development Loan Examination Guidelines

DFS conducts CRA examinations of banks chartered or licensed under the laws of New York¹ to assess their “record of helping to meet the credit needs of local communities . . . consistent with safe and sound operations of banking institutions.”² As part of the examination, DFS evaluates the amount of community development lending, investments, and services made or provided by banks as well as the quality of these activities. In assessing a loan for CRA community development credit, the dollar amount of the loan and the extent to which the loan meets community needs is evaluated.

A loan must have a primary purpose of “community development” if it is to be considered for community development credit. New York and federal CRA regulations define “community development” to include a loan to “affordable housing (including multifamily³ rental housing) for low- or moderate-income individuals” and a loan to “revitalize or stabilize low- or moderate-income geographies; designated disaster areas; or distressed or underserved nonmetropolitan middle-income geographies.”⁴ To determine whether the loan meets community needs, DFS is authorized to consider any additional “information [it] deem[s] relevant.”⁵

DFS intends, going forward, to have its CRA examinations review whether a bank has met its responsibility to ensure that any loan made contributes to, and does not undermine, the availability of affordable housing or neighborhood conditions. In determining whether the loan has a primary purpose of affordable housing, DFS plans to look at whether a loan adds to or reduces the number of units affordable to families with incomes of less than 80% of an area’s median income, the quality of the housing provided, and whether the loan was underwritten in a sound manner. DFS also plans to consider the quality of the housing, the type and quality of commercial, retail, or community facilities provided, as well as whether banks have carefully assessed the true value of their loans in determining whether the loan has a primary purpose of neighborhood revitalization. These valuations should take into account all relevant information including the appraised value of the real property backing the loans.

In addition, DFS plans to review the extent to which banks engage in meaningful dialogue with local government housing departments, community groups, and qualified, preservation-oriented developers regarding the quality of affordable housing. DFS plans to consider as a positive factor whether banks proactively monitor their loan portfolios, including whether multifamily buildings are properly maintained and do not have multiple and egregious building code violations.

A loan on a multifamily property would not be found to have a community development purpose and would not be CRA eligible if it:

¹ “Banks” hereafter. See NYS Banking Law § 28-b (1) & (4).

² 3 N.Y. Comp. Codes R. & Regs. § 76.1.

³ Consistent with federal regulation (12 C.F.R. § 203), DFS considers a property to be “multifamily” if it has five or more units for the purpose of this letter.

⁴ 3 N.Y. Comp. Codes R. & Regs. § 76.2(g) & (f) and 12 C.F.R. § 345.12.

⁵ 3 N.Y. Comp. Codes R. & Regs. § 76.7(b)

1. Significantly reduces or has the potential to reduce affordable housing as determined by:
 - a. The number of affordable units before and after the financing, or a series of re-financings; or
 - b. Financial projections underlying the project that include the conversion of affordable units to market rate rents;
2. Facilitates substandard living conditions as evidenced by a high numbers of housing code violations, emergency repair liens, water bill liens or indexes of such measures such as those contained in the New York City Department of Housing Preservation and Development's ("HPD's") At-Risk Multifamily Building Data⁶, University Neighborhood Housing Program's Building Indicator Project Database,⁷ or other information provided by municipal or state housing agencies;
3. Is in technical default based on the repeated violations of covenants in the loan agreement, even though the borrower might not be in payment default; or
4. Has been underwritten in an unsound manner, based on the assessment of market rents, building expenses and overall debt loads.

Banks will have ample opportunity to provide information to demonstrate the community development impact of loans or investments.

II. Best Practice Recommendations

DFS also recommends that banking institutions consider adopting the following best practices in an effort to help avoid reductions in qualitative or quantitative CRA credit on multifamily loans submitted as part of a CRA examination. DFS encourages all banks to evaluate their multifamily lending programs and incorporate these best practices. These practices, however, are complementary and should not be read as a substitute for any other relevant state or federal law.

1. Appraisals

Banks engaged in multi-family lending should consider establishing and maintaining appropriate appraisal and evaluation policies, procedures, practices, and standards as outlined in the *Interagency Appraisal and Evaluation Guidelines*, dated December 2010.

Banks should take steps to ensure that:

- a. Appraisals contain sufficient information and analysis to support the conclusions drawn based upon the market value without any unusual or limiting conditions;
- b. Individual(s) performing appraisals remain independent of the transactions, are not subjected to undue influence, and report to an individual at the banking institution independent of the lending function;

⁶ More information on the HPD's Office of Enforcement and Neighborhood Services and its enforcement programs can be found at <http://www.nyc.gov/html/hpd/html/about/office-descr-property-services.shtml>.

⁷ More information on the BIP Database can be found at <http://unhp.org/projects/bip-hood-mac>.

- c. Appraisal review processes include formal procedures to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property in question;
- d. Appraisal policies establish clear procedures for the acceptable modification of appraisals and include a tracking and reporting system for such modifications; and
- e. Appraisal policies provide reliable and accurate estimates of current “as-is” market values in order to facilitate accurate loan review, loan grading and financial reporting.

2. Due Diligence

Banks engaged in multifamily lending should adopt due diligence processes that ensure that all new and existing borrowers adequately manage multifamily properties securing any loans. Due diligence processes should, at a minimum, ensure that:

- a. The borrower’s record of housing code violations on current and prior holdings is considered;
- b. Loan applications include information on borrowers' management capabilities and ownership experience, written plans and projections for capital improvements, and any plans for increasing net operating income; and
- c. The buyer’s record of maintaining and improving properties in the bank’s service area is considered in a foreclosure sale.

3. Property Management

Banks originating, holding or servicing multifamily loans should take steps to ensure that multifamily properties are adequately maintained by borrowers, including that:

- a. “Undertaking Agreements” are used and monitored. Undertaking Agreements are written agreements between a bank and borrower concerning the physical condition of the collateral, such as deferred maintenance, code or other violations. In the event the “undertaking” is not satisfied within the prescribed time frame, a bank should, at its option, retain the right to assess a fee and debit it from the escrow balance and/or retain the right to apply the escrowed funds as a principal reduction to the loan;
- b. Violation tracking is enhanced to include cases where:
 - i. Subsequent inspection reveals deferred maintenance;
 - ii. Tenant complaints are identified by media reports and/or a consumer group;
 - iii. Tenant and any relevant complaints are received by an appropriate government agency;
- c. The placement of emergency repair liens is monitored and addressed. In some municipalities unpaid arrears for emergency repairs can be filed as first position liens that take priority over mortgages. In New York City some of these properties can be transferred to a new owner through New York City’s Third Party Transfer Program.⁸ This loss of collateral by the bank should be considered to be a serious risk and should be monitored appropriately.

⁸ For more information see HPD’s website: <http://www.nyc.gov/html/hpd/html/developers/third-party-ownership.shtml>

4. Community Relations

Banks engaged in multifamily lending should develop written community outreach strategies that seek to build or enhance relationships within the neighborhoods serviced by the bank and help to provide a mechanism for the disposition of multifamily properties. At a minimum, the strategies should:

- a. Include a plan for engaging in meaningful dialogue with community groups in areas where the bank operates;
- b. Ensure that the bank communicates its foreclosure processes to community groups;
- c. Provide notice to qualified community groups interested in bidding on multifamily loans and, if a group is not successful in winning a bid, share with the group any commitment made by the buyer to address code violations; and
- d. In those cases where a multifamily property is located in New York City, the bank should consider consulting representatives from New York City's Department of Housing Preservation and Development to discuss for profit and not-for-profit developers that have the experience, financial resources, and capacity required to rehabilitate, maintain and manage multifamily housing.

New York and federal CRA laws were enacted to ensure that banks meet the needs of their entire communities, including low- and moderate-income residents and neighborhoods. The potential for increased speculation in affordable multifamily housing as the housing market recovers must be kept in check by regulatory scrutiny to ensure that New York does not suffer from a repeat of the negative effects of the previous housing bubble. DFS presents these enhanced examination procedures regarding multifamily community development loans and the best practice recommendations as an effort to strengthen the effectiveness of CRA.

Questions with respect to the CRA examination process should be directed to the Director of Consumer Examinations in DFS's Financial Frauds and Consumer Protection Division at (212) 709-1671.

Benjamin M. Lawskey
Superintendent of Financial Services