Fannie Mae®

Supplement 23-02: Inflation Underwriting Guidance

Effective: 06/08/23
Retired: 11/15/24

Summary of Changes

HIGHLIGHTS
Effective as of June 8, 2023, additional underwriting guidance is provided to address the impact of recent inflation on: • calculating operating expenses; • alternative refinance risk assumptions; and • Appraised Values.

Primary Concern

Multifamily Property Net Cash Flows (NCF) have been impacted by current economic conditions, including:

- inflation (near a 40-year high);
- slowing rent growth;
- expense increases above historical averages (especially taxes and insurance); and
- rising interest rates.

Additional Credit Underwriting Guidance

The following additional underwriting guidance should be considered.

Appraised Value

When reviewing the Appraisal:

- ensure the income and expense analysis considers the impact of inflation; and

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- scrutinize the cap rate data given current sales market volatility.

Refinance Risk Analysis Alternative Assumptions

When analyzing refinance risk during inflationary times, you should consider additional alternative assumptions beyond Part II, Chapter 2: Valuation and Income, Section 204.02: Alternative Assumptions, such as:

- increasing the insurance, real estate tax, and other operating expense growth percentage higher than the 3% Base Expense Growth Rate; and
- analyzing expense growth trends by comparing the operating period for the trailing 3, 6, and 12-months to the prior year, excluding non-recurring and extraordinary expenses.

Calculating Underwritten NCF Operating Expenses

Operating Expense	Part II and Part III Underwritten NCF Considerations
Insurance	• For Properties in markets experiencing carrier dislocation (e.g., significant premium increases in Florida and other areas susceptible to natural disaster events), regardless of loss history, consider aligning the expense with the market and obtaining qualified premium quotes prior to Rate Lock. • For all other Properties, if: - an acquisition, ▪ only underwrite premiums from the buyer's carrier, and ▪ disregard the seller's current insurance premiums or estimates; or - a refinance, underwrite to the greater of the: ▪ quoted expense, for insurance policies with a bona fide written quote from a reputable broker for a new 12-month policy; or ▪ percentage increase of the expense from the prior policy period plus 10%. For example, if the insurance expense for the current effective policy increased by 20% over the prior policy period, then the underwritten insurance expense should equal the current expense plus an additional 30% (20% + 10%): • 2022 Insurance Expense: $100,000; • 2023 Insurance Expense: $120,000; • Expense % Increase: 20%; • Additional % Increase: 10%; • Underwritten % Increase: 30% (20% + 10%); and • Underwritten Insurance Expense: $156,000 (130% x $120,000).
Property Management Fee	• Use: - the non-arm's length portion of the fee that is subordinated to the Mortgage Loan; and - any known contractual fee increases during the next 24 months. • Do not use any delegated authority below the minimum 3% of Effective Gross Income unless strongly supported by the market.

Operating Expense	Part II and Part III Underwritten NCF Considerations
Real Estate Taxes	• If recent multifamily sales and/or new multifamily construction have significantly impacted the municipality's assessed values, consider consulting with - a property tax advisor, or - an appraiser. • Underwrite any automatic tax reassessment requiring payment within 36 months after the Mortgage Loan Origination Date. • If market Property values grew significantly during the past 36 months, use the greater of: - prior full year's taxes multiplied by 105% versus current 103% requirement; or - year-to-date annualized expenses. • For all Properties, particularly those in Texas, underwritten real estate tax expense calculations: - should be based on the most recently available assessed value (even if preliminary); and - cannot be based on expected results from a protest, unless the protest is legally binding to the Borrower and taxing authority.
Replacement Reserves	Base the inflation factor on the current Consumer Price Index, especially for Properties projecting significant ongoing deferred maintenance and/or capital improvements during the Mortgage Loan term.
Other Expenses	• Underwrite each operating expense using the highest amount over the trailing 3, 6, and 12-month period, excluding non-recurring and extraordinary expenses. • Trailing 3-month actuals may be more appropriate than trailing 12-month to reflect current inflationary trends. • Reference DUS Insights for comparable expenses, noting the year.

Additional Resources

More information on Fannie Mae's economic outlook is available at:

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- https://www.fanniemae.com/research-and-insights/forecast; or
- https://multifamily.fanniemae.com/news-insights/metro-market-outlook.

Questions

Please contact the Fannie Mae Deal Team with any questions.