



# MULTIFAMILY ACCELERATED PROCESSING (MAP) Guide

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Office of the Assistant Secretary for Housing–  
FHA Commissioner

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# Chapter 1 Introduction

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## 1.1 MAP and the Guide

Multifamily Accelerated Processing (MAP) is designed to establish national standards for approved lenders to prepare, process and submit loan applications for Federal Housing Administration (FHA) multifamily mortgage insurance. The MAP Guide provides - in one volume with appendices – guidance for HUD staff, lenders, third party consultants, borrowers, and other industry partners. Topics include mortgage insurance program descriptions, borrower and lender eligibility requirements, application requirements, underwriting standards for all technical disciplines and construction loan administration requirements. The MAP Guide only applies to FHA multifamily mortgage insurance programs. Except to the extent lender monitoring or enforcement activities overlap, Section 232 and other programs administered by the Office of Healthcare Programs are not addressed by the MAP Guide.

The Guide has been updated to reflect various organizational, policy and processing changes implemented since the last edition was published in 2011. Examples include electronic submission of data in a standardized format, the consolidation of HUD Field Offices, workload sharing, and a “risk-based” underwriting approach. The Multifamily Transformation is consolidating the Multifamily Hubs and Program Centers into Regional Centers and Satellite Offices. The terms Regional Center and Satellite Office are meant to include Multifamily Hubs and Program Centers for those parts of the country that have not yet been consolidated.

Statutory authority for the implementation of MAP is contained in the basic insuring authority for each of the programs covered in MAP, pursuant to the National Housing Act, Sections 220, 221(d)(4), 231, 241(a), 223(a)(7), and 223(f). Additionally, Section 211 of the National Housing Act and Section 7(d) of the Department of HUD Act authorizes the Secretary to make such rules and regulations as may be necessary to carry out the provisions of the Act. The FHA requirements listed in HUD regulations covering each MAP eligible program are included in and more fully explained in this MAP Guide.

## 1.2 Purposes of MAP

The MAP program is intended to provide a consistent, expedited mortgage insurance application process at each HUD Multifamily Regional Center or Satellite Office. HUD no longer accepts new applications for the covered programs, either for Pre-application review or for Firm Commitment review, under local

“fast-track” processing. All MAP eligible projects must be submitted using MAP processing unless a waiver is granted to process under Traditional Application Processing (TAP). Such waiver authority is retained by HUD Headquarters’ Director of Multifamily Production.

Applications for TAP processing require more work and responsibility by HUD staff, and accordingly a higher application fee may be charged. Projects not eligible for MAP, and which may be submitted under TAP are:

- Applications submitted by FHA approved multifamily lenders who are not approved to submit MAP applications,
- Applications where there is an identity of interest between the lender and the borrower or affiliates of either, or
- Applications for mortgage insurance under Programs or Sections of the Act not covered by MAP (e.g. Cooperatives under Section 213).

Some MAP approved Lenders (MAP Lenders) only originate loans and do not close or service them. After obtaining a Firm Commitment for mortgage insurance under MAP, the originating lender may sell or transfer the Firm Commitment to another MAP Lender, so long as the MAP Lender closing the loan does not have an identity of interest with the borrower for this project. The second MAP Lender will close the loan, oversee the construction loan administration, if applicable, and service the loan in accordance with HUD requirements. At the Pre-application submission, the originating lender should inform the Regional Center or Satellite Office if it does not intend to service the loan or administer the construction loan. The originating lender must identify which lender will be responsible for those functions as soon as the closing / servicing lender is identified. The second lender must identify their construction loan administrator before or at initial endorsement. A loan servicer who receives a transferred MAP loan for servicing must be FHA approved for multifamily housing and have an approved Construction Loan Administrator, unless the loan is a refinancing with no repair escrow. The servicing lender generally is, but is not required to be, a MAP approved Lender.

MAP is intended to:

- A. Increase HUD’s reliance upon the lender’s due diligence, and increase the MAP Lender’s accountability for its due diligence and underwriting.
- B. Establish a process that significantly reduces the amount of HUD review time.
- C. Strike a careful balance between expedited processing and ensuring an acceptable level of risk management for HUD’s multifamily mortgage insurance programs.
- D. Have in one volume, the MAP Guide, the basic information required for loan origination by the lender and for review by HUD staff.
- E. Bring Handbook and Notice instructions current and maintain up-to-date instructions through amendments to the MAP Guide.
- F. Provide the lender with predictable and consistent underwriting guidelines, thus facilitating efficient processing and better service for borrowers.

## 1.3 Brief Summary of MAP

### A. Lender Qualifications and Monitoring.

By permitting a MAP lender to prepare much of the documentation for an application for mortgage insurance, HUD places confidence in the lender's integrity and competence. A lender wishing to submit a MAP application must be:

1. An FHA approved lender. See the Mortgagee Approval Handbook (4060.1).
2. Approved by the Asset Management and Counterparty Oversight Division (AMCOD, formerly Lender Qualification and Monitoring Division or LQMD) at HUD Headquarters. See Chapter 2 of the MAP Guide.
3. Subject to Quality Assurance Enforcement Actions. See Chapter 15 of the MAP Guide.

### B. Programs Covered by MAP.

MAP may be used for the following programs, identified by section of the National Housing Act:

- 220 - new construction or substantial rehabilitation of mixed use projects in urban renewal areas;
- 221(d)(4) - new construction or substantial rehabilitation of apartments,
- 223(a)(7) - refinancing of FHA insured mortgages;
- 223(f) - refinancing or purchase of existing apartments;
- 231 - new construction or substantial rehabilitation of housing for the elderly; and
- 241(a) - Supplemental Loan program for rehabilitation or additions to projects which have an FHA insured first mortgage.

### C. Application processing instructions are described in Chapter 4. Standard Processing Times are detailed in Appendix 1 to this Guide. All periods longer than two weeks are described in calendar days, and periods of two weeks or less, in business days.

HUD has certain responsibilities which it does not assign to the lender, including responsibility for the environmental clearance on Form HUD-4128 (even though the lender prepares information for HUD's review), approval of the borrower's Affirmative Fair Housing Marketing program, and issuing the commitment for mortgage insurance.

### D. Construction Responsibilities.

1. Under MAP, HUD must approve the initial and final draws.
2. HUD will contract, or perform or otherwise provide, for inspection duties and will provide copies of the Trip Report to the MAP lender. Generally, HUD will rely on one inspection per month, however the Multifamily Regional Director has discretion to require additional inspections based on fact specific circumstances.
3. The MAP lender will prepare and approve the interim draws during construction.
4. HUD must approve the construction amount for each item in the initial and final advance, and for each Change Order during construction.

E. Servicing.

MAP makes no changes in procedures for servicing or asset management, except for servicing lenders with prior approval for delegated responsibility for repair escrow administration. See Section 1.2 above for guidance on MAP approved lenders who only originate and transfer loans to another FHA approved lender for servicing.

## 1.4 Relation of MAP to Handbooks, Notices and Regulations

- A. All applicable HUD Handbooks, Notices and Forms remain in effect and will be used for traditional HUD processing of mortgage loan applications. For applications under MAP, the Guide incorporates the majority of Handbook, Notice and Mortgagee Letter requirements and includes in the Appendix the forms that are required for most applications. If there is a conflict between the Guide and the Handbooks or instructions for various HUD forms, the Guide will take precedence. Lenders with questions should address them to the Regional Center or Satellite Office processing the application. Where the Guide is silent on a matter, the lender should consult the following MAP website: <http://www.hud.gov/offices/hsg/mfh/map/maphome.cfm>, or the Regional Center or Satellite Office processing a particular application.
- B. Consistent with their level of approval, the lender must be familiar with the basic programmatic requirements and regulations of the insurance programs set forth in 24 Code of Federal Regulations, including but not limited to Part 200.
- C. The lender is encouraged to contact a Regional Center or Satellite Office if any issues are not addressed in the Guide or if any clarifications are needed. See Chapter 11 on Underwriting for waiver procedures. The Multifamily Regional Director may waive non-regulatory or non-statutory provisions of the Guide, although Chapter 11 specifies a number of requirements that may not be waived without prior approval of HUD Headquarters (HQ). Regulatory provisions may be waived only on approval of the Assistant Secretary for Housing - FHA Commissioner. Statutory provisions may not be waived.
- D. The lender is also encouraged to communicate early with the borrower to ensure that the borrower, the proposed management agent, and/or the Project have not been referred to HUD's Departmental Enforcement Center (DEC), as such referrals may require additional time to resolve and create impediments to a timely closing.
- E. Any waiver of this Guide granted by the Multifamily Regional Director must be documented in the Regional Center or Satellite Office docket, along with the lender's request and supporting documentation for the approval. The Form HUD-2 must be submitted electronically to the HUD HQ Office of Multifamily Housing Production's SharePoint site in accordance with outstanding instructions. No hard copies need to be submitted to HQ; Multifamily Field Office staff and OGC may rely on electronic signatures or scanned copies. HQ will periodically review waivers to determine if changes to the Guide or to the regulations are appropriate.
- F. Program Obligations. HUD made technical and substantive changes when it adopted new and updated FHA multifamily loan closing documents. The term "directives" was eliminated and substituted with the term "Program Obligations." "Program Obligations" refer to:

1. All applicable statutes and any regulations issued by the Secretary that apply to the Project, including all amendments to such statutes and regulations, as they become effective, except that changes subject to notice and comment rulemaking shall become effective only upon completion of the rulemaking process, and
2. All current requirements in HUD handbooks and guides, notices, and mortgagee letters that apply to the Project, and all future updates, changes and amendments thereto, as they become effective, except that changes subject to notice and comment rulemaking shall become effective only upon completion of the rulemaking process, and provided that such future updates, changes and amendments shall be applicable to the Project only to the extent that they interpret, clarify and implement terms in the applicable closing document rather than add or delete provisions from such document. Handbooks, guides, notices, and mortgagee letters are available on HUD's official website:

[\(http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/\)](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/)

## **1.5 Workload Management**

- A. Applications for mortgage insurance should be submitted to the Regional Center or Satellite Office having jurisdiction for the area where the property is located (the “originating” office). The Regional Center or Satellite Office Director is responsible for workload management within their Regional Center or Satellite Office, including:
  1. Delegation and staff assignments,
  2. Participation in Workload Sharing,
  3. Establishing priority of application processing,
  4. Meeting standard processing times, and
  5. Loan Committee.
- B. Workload Sharing. Depending on staff capacity and programmatic expertise, a Regional Center Director may transfer processing assignments to other Multifamily Regional Centers or Satellite Offices (“processing” offices) through Workload Sharing. Workload sharing occurs outside if the geographic service area identified in existing published delegations of authority. The originating Multifamily Regional Director will retain Commitment Authority and closing responsibility. The processing office will provide assistance as requested, following protocols of the originating office and counsel. A Regional Center Director may re-delegate processing responsibilities to designated Multifamily staff in processing offices unless specifically restricted by the Guide, statute or regulation or by existing published delegations of authority.
- C. Washington Docket. At the “initial”/“final” endorsement and closing, the Regional Center’s Closing Coordinator or other appropriate designated staff should assemble a set of original documents (or as HUD allows, copies) for the Washington Docket, in accordance with the requirements and procedures set forth in the MAP Guide Appendix 11E. If originals of recorded documents are unavailable because of filing or recording procedures, a completely legible copy should be collected (certified true and correct by the recorder or by the title company). Note that the Phase I Environmental Site Assessment is a program requirement and a supporting document

for form HUD-4128, *Environmental Assessment and Compliance Findings for the Related Laws*. It should remain with the HUD-4128 in the Washington Docket as a part of the permanent, historical file.

- D. Initial Endorsement Diligence Review. The Regional Center Director and program staff will review the lender's request for initial endorsement and closing, and supporting materials in accordance with Program Obligations. In this review, the Multifamily Regional Director and program staff should confirm the information listed on the Initial Endorsement Diligence Review Worksheets, attached in the MAP Guide Appendices 11A – 11D, and may use such worksheets to document compliance with Program Obligations. Applications participating in Workload Sharing will follow closing requirements and protocols of the originating office and counsel; the processing office will provide such support as requested.

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## Chapter 2 Lender and Underwriter Qualifications

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### 2.1 Introduction

- A. MAP requires lenders and underwriters to be skilled in underwriting multifamily housing loans and in preparing applications for FHA multifamily mortgage insurance. MAP Lenders and their Underwriters must be approved by the Multifamily Asset Oversight Division (“MACOD”).
- B. Approval of a MAP Lender or underwriter by the Multifamily Asset Counterparty Oversight Division is on a nationwide basis, so that the MAP Lender and their Underwriter may process MAP loans regardless of which Regional or Satellite Office will be processing the loan. By accepting the opportunity to use MAP, a MAP Lender and Underwriter agrees that its MAP loans will be subject to post-endorsement review by the Multifamily Asset Counterparty Oversight Division and that if it fails to meet HUD standards for underwriting loans, its MAP designation may be terminated. MAP approval does not expire but may be terminated in accordance with the Quality Assurance Enforcement Actions in Chapter 15.
- C. Approval by the Multifamily Asset Counterparty Oversight Division as a MAP Lender is a prerequisite to participation in the MAP program, but MAP approval does not obviate the need to have an experienced team on each application. If the HUD office has concerns regarding the MAP Lender’s or its Underwriter’s performance or capabilities, the office should consult with the Multifamily Asset Counterparty Oversight Division for additional monitoring or potential enforcement action.

The MAP Lender is responsible for insuring that all third party contractors meet the requirements outlined in the MAP Guide, including the USPAP Competency provision and jurisdictional certification requirements. If the HUD office has concerns regarding the third party contractor’s past performance or capabilities, the office should consult with the Multifamily Asset Counterparty Oversight Division for potential enforcement action.

- D. The originating MAP Lender may sell or transfer a MAP application only upon receipt of a Firm Commitment. The application may only be sold to another MAP approved lender not currently subject to any suspension or Limited Denial of Participation penalties, and within the limitations on MAP Lenders with identities of interest with the Borrowers (or affiliates of both). See Section 1.2 for additional details.

## 2.2 Lender Qualifications

- A. Lender MAP approval requests should be sent to:

Multifamily Asset Counterparty Oversight Division  
Office of Multifamily Development  
451 7<sup>th</sup> Street, SW, Room 6151  
Washington, DC 20410  
FAX Number: 202-401-9087

- B. The lender prepares the application for approval as a MAP Lender. There is no specific required form for this application. Upon receipt of all the information specified in Section 2.8, the Multifamily Asset Counterparty Oversight Division will process the application within 30 days.
- C. The Director of the Multifamily Asset Counterparty Oversight Division must approve each MAP Lender in writing. The names of approved MAP Lenders will be posted on the HUD website at:

<http://www.hud.gov/utilities/intercept.cfm?/offices/hsg/mfh/map/aprvlend.pdf>,

And for the HUD staff at:

<http://hudatwork.hud.gov/po/h/hm/fog/dev/authsign.pdf>.

- D. The Multifamily Asset Counterparty Oversight Division may disapprove an application on the grounds that: a) it fails to meet the standards set forth in Section 2.3, b) it fails to provide sufficient information required by Section 2.8 or, c) there are specified deficiencies that must be corrected. An appeal of the Multifamily Asset Counterparty Oversight Division's decision to disapprove an application, or specific conditions of approval, may be made to the Deputy Assistant Secretary for Multifamily Housing.
- E. If the MAP Lender's approval has been terminated, the Lender may not reapply for 12 months after termination. (See Chapter 15, Section 15.8.E) The lender may appeal its termination as provided in Chapter 15, Section 15.15.
- F. The applicant should submit one complete hard copy and an electronic version of the application.

## 2.3 Standards Required for Qualification

A MAP Lender must demonstrate that it is an FHA approved multifamily mortgagee pursuant to 24 CFR Part 202, that it is financially sound, that it has on staff principal employees with the necessary multifamily underwriting experience required by this Guide, and that its record with FHA-insured or

conventional multifamily loans has been satisfactory. An FHA Lender will not be granted MAP approval if the lender uses contract underwriters. The requirements are discussed in this Section below:

- A. A Lender must be an FHA-approved multifamily mortgagee as a result of submitting Form HUD-92001-B, Branch Office Notification Title I/ Title II to the Office of Lender Activities.
- B. The Lender must not be subject to judgments, administrative claims, or lawsuits, which would seriously affect its ability to do business and must not unlawfully discriminate.
- C. Multifamily underwriting experience on staff is a key to MAP approval. The Lender must identify staff persons with the level of training and experience required pursuant to Section 2.11 below. The Underwriter must have worked regularly in the multifamily lending business and have underwritten the required number of transactions pursuant to Section 2.11 below, which have been funded. HUD will verify that the Underwriter has attended a MAP training session conducted by HUD before submitting an application or pre-application submission. HUD will defer this requirement for otherwise qualified underwriters until such training is offered. MAP training will be held periodically by HUD. Training announcements will be posted on the MAP home page website under MAP Underwriting training at:  
<http://www.hud.gov/offices/hsg/mfh/map/maptraining.cfm>
- D. The lender's application must identify experienced staff who have the authority to underwrite loan applications and sign the narrative summary in a loan application. The applicant must also identify whose signatures may bind the Lender for its responsibilities under MAP.
- E. FHA multifamily experience is not specifically required for initial approval as a MAP Lender, but if the Lender lacks FHA experience, additional emphasis will be placed on consistent and recent analogous conventional multifamily lending experience. For any loan processed under MAP, the lender must thoroughly understand FHA requirements for its mortgage insurance programs.
- F. A lender may be rejected for MAP qualification for a recent history of early defaults, foreclosures, or assignments of FHA-insured loans. The reason for any assignments, early defaults or foreclosures will be subject to the evaluation of the Multifamily Asset Counterparty Oversight Division. There may be a variety of reasons for assignments, such as unpredictable economic changes in the area, inadequate servicing or poor quality underwriting. Multifamily Asset Counterparty Oversight Division will review any loan which the applicant has underwritten and endorsed within the previous five years and which has defaulted and been assigned to HUD. The purpose of the review will be to determine whether the Lender was at fault in its origination of a loan that did not perform satisfactorily, or if there was a pattern of poor performance.
- G. If the Lender has worked with HUD's Regional and Satellite Offices (or Hubs and Program Centers) in the previous two years, the Multifamily Asset Counterparty Oversight Division will contact those offices to ascertain their experience with the applicant and the responses will be included in the Lender's file. A pattern of unsatisfactory applications at one or more Hubs or Program Centers may be grounds for rejection of the Lender.

## 2.4 Loan Consultants/Loan Brokerage

It is common practice for Lenders to use consultants, individuals and companies, to increase origination and underwriting capacity. The term consultant, as used here, applies to a mortgage broker, loan correspondent and packager who is not a MAP approved Lender. A consultant may have the following roles in FHA multifamily programs:

- A. Under TAP, the consultant may refer new business to a Lender including information supplied by a proposed borrower/sponsor.
  - 1. The consultant may provide a wide range of additional services to the Lender. HUD offices may accept application packages, correspond with and rely on information submitted by the consultant on behalf of the Lender.
  - 2. The consultant's fee is paid solely from either:
    - (a) the mortgagee's fees, or
    - (b) the borrower or sponsor or affiliated entities.The consultant cannot be paid from both sources.
  - 3. The consultant cannot have any identity of interest with the borrower, sponsor or affiliated entity. HUD may permit an exception to the rule if:
    - a) The consultant's regular business is brokering and processing loans; and
    - b) The relationship is fully disclosed to and approved by HUD before an application for mortgage insurance is submitted.
- B. Under MAP, the consultant's sole role is to refer new business to a MAP Lender including information supplied by a proposed borrower/sponsor.
  - 1. The consultant's fee must be paid solely from the Lender's fees, and must be disclosed in the MAP Lender's underwriting narrative.
  - 2. The consultant cannot have any identity of interest with the Borrower/sponsor or any affiliated entity.

There is no additional role for the consultant. HUD only accepts application packages from, corresponds with, and relies on information submitted by an approved MAP Lender. HUD will only deal with employees of the MAP Lender and only accept documents signed by authorized signatories of the MAP Lender. MAP Lenders are expected and authorized to hire third party contractors for appraisal, architecture and cost, market analysis, environmental reports and environmental site assessments, and specialized reports related to any of these

technical disciplines; involvement by a consultant or broker in any of these functions is unacceptable under the MAP Program.

## **2.5 MAP Lender Underwriting and Construction Loan Administration Requirements**

### **A. Major Duties and Responsibilities of the Underwriter.**

The MAP Underwriter performs the mortgage credit and real estate underwriting function and must be a full time employee. The third party contractors cannot have any identity of interest with the Borrower/sponsor or any affiliated entity. The MAP Lender is responsible for underwriting the loan. This responsibility necessarily requires the lender's oversight, acceptance and recommendation to HUD for approval of the conclusions and recommendations of the third party reports, except as modified, explained, and justified in their underwriting.

The Underwriter or the Construction Loan Administrator is responsible for management of the Lender's responsibilities during the construction period.

Duties and responsibilities associated with the application underwriting are as follows:

1. Make a determination of the acceptability of the general contractor, supervisory architect, management agent, the sponsor, the Borrower, if formed, and its principals through a thorough analysis of their experience, credit, character, financial condition, and motivation for ownership (e.g., are they a merchant builder, plan to hold for long term, refinancing balloon debt), availability of assets for closing and adequacy of income for total obligations.
2. Use trade references, bank references, credit data and construction experience resumes in analyzing the construction capability of the general contractor including financial stability, and ability to complete the project in light of their responsibility for other projects in progress.
3. Determine the recommended maximum mortgage amount and other key terms of the loan.
4. Engage all third party consultants and analysts, provide oversight and effective supervision of work performed under their contracts to ensure their deliverables meet MAP Guide requirements and support the underwriting recommendation. The Underwriter oversees packaging of the loan, and recommends loan approval (or rejection).

### **B. Duties and responsibilities of the Construction Loan Administrator during the construction period are:**

1. Initial distribution of mortgage proceeds into various accounts and maintain a record of control and disbursement thereafter.

2. Determine construction cost (as approved by the HUD inspector), architect fees and carrying charges payable under request for advances of multifamily mortgage proceeds, prepare written reasons for modifications as necessary.
3. Recommend approval of construction change orders and recommend release of both on-site and off-site escrow funds, citing special requirements or conditions of approval as necessary.
4. Protect HUD's interest by assistance and oversight of the resolution of construction disputes, delays, costs overruns, and related problems.

#### C. Major Duties and Responsibilities of HUD.

1. During application underwriting:
  - a. Review the Lender's mortgage credit report(s) regarding the acceptability of the sponsor, Borrower, and its principals, and the contractor.
  - b. Perform the Active Partner Performance System (APPS) Electronic 2530 Property Submission review or successor previous participation review process.
  - c. Determine the maximum mortgage amount, financial settlement requirements, and other key terms of the loan.
  - d. Determine the project's financial feasibility and the acceptability of the market.
  - e. Review initial and final closing documents for compliance and acceptability.
2. During the construction period:
  - a. Review and approve the Lender's proposed initial distribution of mortgage proceeds.
  - b. Provide for construction inspections on behalf of HUD.
  - c. Require the Lender to ensure resolution of construction problems and disputes.
  - d. Approve construction change orders.
  - e. Review the borrower's cost certification based on HUD allowed costs.
  - f. Determine the final maximum insurable mortgage.
  - g. Review and approve the final distribution of mortgage proceeds.

## **2.6 Electronic Capability and Internet Access**

MAP Lenders must have electronic capability and internet access. HUD will post information on its web site and will transmit messages to Lenders and to the lending community by electronic mail, often with attached documents, Mortgage Letters, or HUD Housing Notices. Much of the information required by HUD must be submitted electronically.

Lender and Underwriter approval requests sent to the Multifamily Asset Counterparty Oversight Division should include one paper copy and an electronic version.

## **2.7 Identity of Interest**

### **A. Introduction.**

The term “Identity of Interest” is used in 24 CFR subpart Y (e.g., 24 CFR 1530(b)(6).) A prohibited Identity of Interest is referred to in this Section as a “Conflict of Interest”.

MAP Lenders may not have a Conflict of Interest that would:

1. undermine the independence and integrity of the MAP Lender’s underwriting, credit review process, and loan closing process;
2. obscure the lines between the MAP Lender’s fiduciary responsibilities to the investor and its responsibilities to HUD;
3. represent an unfair competitive advantage to the MAP Lender; or
4. represent an unfair business practice with the Borrower or any of its affiliates, e.g., due to a lack of disclosure or skewing arm’s length incentives.

Unless explicitly permitted pursuant to this section or approved in writing by HUD, an Identity of Interest (IOI) relationship between a MAP Lender and any party related to the MAP loan being processed creates a Conflict of Interest and is prohibited.

HUD considers certain prohibited payments and/or promises by a MAP Lender to be a violation of 24 C.F.R. 200.1530(b)(7), which reads:

payment by, or receipt of a payment by, a MAP lender of any kickback or other consideration, directly or indirectly, which would affect the lender’s independent evaluation, or represent a conflict of interest, in connection with any FHA-insured mortgage transaction.

Certain payments and/or promises could further violate the following Lender’s Certificate (HUD-92434M) and the Request for Endorsement (HUD-92455M, Certificate of Lender) provision:

Lender has not made or offered, and shall not make or offer, any guarantees, pledges, reservations of sums to become due, or other inducements to any entity or person to make

loans or advances which Lender would be prohibited from making under the terms of this Section.

Lenders who violate the prohibition against IOIs may be subject to enforcement action by the Department, including, but not limited to, sanctions under 24 CFR part 200, subpart Y (MAP Lender Quality Assurance Enforcement) and part 25 (Mortgagee Review Board).

Prohibited Conflicts of Interest, and acceptable Identity of Interest relationships and permissible exceptions are detailed in this section; examples are provided in Appendix 2. IOI relationships which could be a Conflict of Interest must be disclosed and reported to the Multifamily Asset Counterparty Oversight Division (MACOD). Because determining whether an Identity of Interest is acceptable or not is inherently complex and may lead to enforcement action, Lenders and other participants should obtain written HUD approval prior to proceeding when there is any question whatsoever. MACOD will provide responses to written requests for IOI approvals pursuant to this section.

## **B. Definitions.**

In this section the term “MAP Lender,” unless otherwise specified, includes the FHA-approved MAP Lender, its parent company, subsidiaries, affiliates and any other related entities, and any officers, directors, partners, members or employees of the MAP Lender, its affiliates and other related parties. The term “Identity of Interest” is defined as a financial or family relationship between a MAP Lender and another party related to the MAP loan transaction.

Shareholder and employment interests in widely-traded public companies resulting in an interest in both the MAP Lender and another party on a MAP loan, which would otherwise be a prohibited IOI, may be permitted depending on the specific roles and potential influence on the transaction. The “Borrower’s Team” includes the FHA Borrower, Borrower’s counsel, general contractor, subcontractor, architect, seller of the land, seller of the property, a third party consultant providing reports supporting the transaction, any affiliates of the Borrower’s Team, or parties related to the Borrower’s Team.

For the purposes of this section, “financial relationship” includes, but is not limited to, debt or equity interests, employment, and fiduciary relationships. “Family relationship” includes, but is not limited to, spouses, parents, siblings, children, grandparents, grandchildren, aunts, uncles, mothers-in-law, fathers-in-law, brothers-in-law, and sisters-in-law.

## **C. Lender Responsibilities and General Guidance.**

The MAP Lender is responsible for conducting appropriate commercially reasonable due diligence to identify identities of interest and ensure no Conflicts of Interest exist. Because the guidance in this chapter is necessarily general, the Lender is responsible for obtaining prior written approval from HUD when there are questions as to whether an Identity of Interest is prohibited in any particular situation.

In some cases, the MAP Lender is a Supervised Mortgagee, as defined in Section 1-2.A. of HUD Handbook 4060.1, or a publicly owned company (or wholly owned subsidiary of a publicly held company) subject to oversight by the U.S. Securities and Exchange Commission. Such entities are actively regulated by other federal agencies and thus HUD's risk in identity of interest situations is partially mitigated. Due to the size and number of shares and employees, it may be impractical for such entities to provide certainty that there is no identity of interest. Accordingly, for purposes of determining whether a prohibited Conflict of Interest exists, Supervised Mortgagees or publicly owned MAP Lenders may define in their Quality Control Plan the MAP Lender as the applicable operating entity responsible for origination and servicing of "agency business", which would include both FHA and GSE loans. The Quality Control Plan must describe the due diligence process used to ensure shareholder or employee identities of interest are sufficiently remote such that they will not undermine, or give the appearance of undermining, the MAP Lender's or Borrower's Team member's integrity and independence in the underwriting, credit review, and loan closing process.

Generally, MAP Lenders who are Supervised Mortgagees or Publicly owned companies can assume counterparties in MAP transactions with less than a 5% shareholder interest, or depositories with less than \$500,000 in an account, would not have a Conflict of Interest.

Lenders are expected to perform commercially reasonable and appropriate due diligence in evaluating Borrower team members. Generally, certifications by Borrower Counsel, Design Architects, and other professional advisors (including MAP Lender Third Party professional reviewers) with no equity in the MAP transaction apply to themselves and other principals of their firms and may be relied upon. Similarly, certifications by non-Identity of Interest General Contractors may be relied upon as applying to principals of their firms and sub-contractors.

Borrower team members subject to Previous Participation review are assumed to be subject to identity of interest disclosure and prohibitions, as are entities or persons with equity or other financial interests in the borrower such that their role in the transaction provide material control or influence over the development, operations, or management of the project.

#### **D. Programmatic Guidance Section 223(a)(7) Refinancing Applications.**

**MAP Lenders with ownership interests in properties with currently FHA insured mortgages.** MAP Lenders with ownership interests in properties with currently FHA insured mortgages would have an identity of interest if they refinanced the loan. This is not prohibited, so long as the MAP Lender discloses to HUD the relationship in writing prior to submitting the Firm Commitment application, and the terms and interest rate are commercially competitive at the time of the refinancing.

**Secondary Financing Relationships.** Secondary financing includes, but is not limited to:

- a. loans secured by the project or made to the Borrower entity in addition to a first mortgage;

- b. loans made to and/or secured by upper tier ownership interests in the Borrower entity (i.e., persons or entities with any ownership interest in the FHA loan Single Asset Mortgagor Entity); and
- c. other forms of mezzanine financing associated with the project proposed for the MAP loan transaction.

Any proposed secondary financing relationship between the Borrower and the MAP Lender on a MAP application constitutes an IOI and unless explicitly allowed in published program guidance must be disclosed in writing to HUD, and the MAP Lender must receive written approval of the IOI from MACOD before submitting an application. Such approval will not be unreasonably withheld provided the relationship is fully disclosed and the parties demonstrate to HUD's satisfaction the relationship will not undermine the MAP Lender's integrity and independence in the underwriting, credit review, and loan closing process. These situations will require additional scrutiny by HUD and the MAP Lender to ensure an appropriate valuation and compliance with program requirements. In cases where a secondary financing IOI occurs during or after processing, it must be disclosed in the manner provided in this section as soon as it is anticipated.

**Bridge Loans and Balance Sheet Loans.** An IOI is created in cases where a temporary bridge loan is made by the MAP Lender to the Borrower, as well as in cases where a loan on the MAP Lender's balance sheet will be refinanced using FHA mortgage insurance. Existing or potential Bridge and balance sheet loans require disclosure of IOIs at the earlier of Concept Meeting or submission of the loan application. Generally such IOIs will be approved if HUD determines, based on the facts and circumstances submitted in writing by the MAP Lender, that the relationship does not:

1. undermine the integrity and independence of the underwriting;
2. circumvent program requirements; or
3. undermine program intent, for example by facilitating cash out on either a Section 223(a)(7) or a Section 223(f) loan greater than 80% LTV.

**Tax Credit Syndicator or Investor Relationship.** In all instances where there is an IOI or any type of affiliation between the MAP Lender and the tax credit equity syndicator or investor, the MAP loan must be processed, underwritten, and approved by the MAP Lender's staff without involvement by the affiliated tax credit equity syndicator's or investor's staff.

**MAP Lenders who are approved as Supervised Mortgagees and large publicly owned companies with affiliated tax credit investment entities.** With prior written approval from the HQ Director of MF Production, certain MAP Lenders with tax credit investor affiliates may originate FHA-insured MAP loans. Approval of such requests shall be conditioned on:

- a. the MAP Lender is a Supervised Mortgagee, as defined in Section 1-2.A of HUD Handbook 4060.1, or a publicly owned company (or wholly owned subsidiary of a publicly held company) subject to oversight by the U.S. Securities and Exchange Commission;
- b. and except where HUD agreed to a “Pre-Approval of Special Limited Partners As Interim Replacement GP/MM for LIHTC Transactions”, the equity investor must remain in a purely passive role throughout the term of the FHA-insured loan, including after the Tax Credit compliance period ends.

MAP Lenders who are not Supervised Mortgagees or publicly held may still invest in tax credit transactions, subject to compliance and certification that after the project’s placed in service date, the affiliated tax credit equity syndicator or investor holds no more than a twenty five (25) percent ownership interest in the Borrower entity.

**Identity of Interest Servicing.** MAP Lenders may occasionally seek to invest in multifamily projects financed by another MAP Lender using the MAP program. If the Borrower has an IOI relationship with a MAP Lender, that MAP Lender cannot assist in underwriting, purchase, or service the loan until after final endorsement. The arrangement to assign the loan after final endorsement is subject to full disclosure before processing begins, certification, approval by HUD, and development of procedures implemented into each lender’s Quality Control Plan (QC Plan). The risk must be mitigated pursuant to the following requirements:

1. The IOI relationship must be fully disclosed as a planned business practice in both lenders’ QC Plans. With each application, the Underwriting MAP Lender must include a certification that includes the applicable criminal penalty warning. The warning must certify that the brokering lender had no involvement in the underwriting process, and that the referring entity had a “firewall” such that only employees of the owner/ equity investor affiliate of the broker provided information to the Underwriting MAP Lender.
2. The Underwriting MAP Lender must have made no specific written or oral obligation to assign the loan to the IOI Map Lender after final endorsement. The Underwriting MAP Lender must retain the right to assign the loan to any servicer, or to hold the loan.
3. The IOI Map Lender must have made no written or oral obligation to purchase the loan from the Underwriting MAP Lender. The IOI MAP Lender must retain the right to purchase, or refuse to purchase, the loan.
4. Any dealings between the IOI MAP Lender and the Underwriting MAP Lender must be arm’s length and independent at all times, including after issuance of a Firm Commitment.
5. The IOI MAP Lender may not advise or assist the Underwriting MAP Lender in processing the loan or with making underwriting decisions in any way.
6. The IOI MAP Lender cannot receive a broker’s or consultant’s fee from mortgage proceeds.

7. HUD will only accept application packages, correspondence, and information related to the loan submitted by the Underwriting MAP Lender.
8. The IOI MAP Lender may not hire or interact with third-party contractors other than the equity affiliate responding to inquiries from the Underwriting MAP Lender's third parties. Such interaction must be isolated by the firewall described in the Quality Control Plan.
9. Third-Party contractors cannot have any IOI with the Borrower or the Underwriting MAP Lender.
10. Both lenders must have appropriate and acceptable quality control practices that provide for an effective firewall. It must allow objective and independent origination and underwriting. Such practices and procedures must be defined in each MAP Lender's quality control plan, and approved by the Asset Management Counterparty Oversight Division (MACOD).

#### **E. Prohibited Business Practices.**

**Inducements.** A MAP Lender cannot have arrangements with Borrowers for the purpose of securing the Borrower's business that may undermine the MAP Lender's integrity in underwriting and credit review process or provide an unfair competitive advantage to the MAP Lender. Following are examples of prohibited MAP Lender inducements. The MAP Lender cannot:

- a. provide "kickbacks" to Borrower;
- b. issue loans between affiliates of either the MAP Lender or the Borrower for the purpose of meeting requirements for cash or financial capacity related to the MAP transaction;
- c. condition the provision of, or provide more desirable terms for other bank products including Tax Credit investments by affiliated entities on engagement for an FHA insured loan;
- d. pay the Borrower's costs for third party reports;
- e. pay application fees;
- f. offer to refund application fees on unsuccessful loan applications.

**Note:** this list is not intended to be exhaustive. Any similar payment made by MAP Lender to the Borrower to secure loan origination business must be disclosed to and approved in writing by HUD.

The prohibition on inducements does not prevent a MAP Lender from paying for updated third party reports provided the transaction was already submitted with a Firm Commitment application that was delayed in processing due to no fault of the Borrower.. The lender must provide to MACOD and the Director of Multifamily Production in HUD Headquarters a written notice and detailed explanation of any transaction in which such funds are greater than \$10,000.

**Gifts.** A prohibited IOI can be created when the MAP Lender, Borrower, or other parties to a MAP loan solicit or accept gifts from prohibited sources based on their business relationship. Gifts less than \$200 per year to a particular recipient are presumed to not constitute a prohibited IOI. A gift cannot be conditioned on an agreement or obligation to do business related to a MAP loan. Gifts given based on an existing business relationship outside of the MAP loan or incidental to commercially reasonable and customary marketing practices are not prohibited unless the value, amount, or circumstances undermine, or give the appearance of undermining, the integrity and independence of the underwriting and credit review process. The MAP Lender's Quality Control Plan must address their policy on this topic.

**Charitable Donations.** From time to time MAP Lenders will make charitable donations to causes that may create a conflict of interest. HUD does not prohibit charitable contributions by MAP Lenders or borrowers. Such contributions, however, can result in a Conflict of Interest for MAP purposes. If a donation to the charity was given by any party in a MAP transaction conditioned upon an agreement or obligation related to a MAP loan, it would create a prohibited IOI whether such condition is written or not. In situations HUD becomes aware of such contributions that may constitute a Conflict of Interest, enforcement will be pursued if HUD determines the gifts were intended for the purpose of competing for FHA mortgage insurance. The six main factors considered by HUD are:

1. Whether or not the donor disclosed such charitable donations in advance. The donor may provide documentation of monetary value, history of donations to a particular charity, history of donations to a variety of similar charities, or other information it deems relevant to show that the donation is not based on, and would not influence the underwriting of, a MAP transaction.
2. timing;
3. monetary value or amount of the gift;
4. implicit or explicit understanding that the contribution is a condition of doing the deal;
5. history of philanthropic contributions; and
6. the specific roles and relationships between the parties involved.

## **F. Disclosure Requirements.**

1. **Generally.** Disclosure is required where there is an actual IOI, the appearance of an IOI, or potential for an IOI between the MAP Lender and the Borrower's Team or any other party to the MAP loan. All questions and supporting documentation, including any additional information requested by the Regional or Satellite Office, must be submitted to HUD Headquarters. Send such requests to:

Director of Multifamily Housing Production, Headquarters  
ATTN: Multifamily Asset Counterparty Oversight Division  
451 7<sup>th</sup> Street, SW, Room 6134  
Washington, DC 20410  
FAX Number: (202) 401-9087

2. **IOI Discovered Before Processing.** If an Identity of Interest is identified and a MAP Lender has not started processing, the MAP Lender must disclose the IOI to HUD and request HUD's written approval of the IOI before continuing; or in the alternative, the MAP Lender may undertake one of the following measures:
  - a. review and submit the transaction under the traditional application processing program;
  - b. remove the IOI stakeholder from the transaction and process the transaction using MAP; or
  - c. immediately transfer the project to a new MAP Lender. The new MAP Lender cannot assign the pre-application submission, the firm commitment application, the mortgage insurance commitment, or the insured loan back to the IOI lender prior to Final Endorsement.
  
3. **IOI Discovered During Processing.** If an IOI becomes apparent during processing, a MAP Lender must immediately stop processing, disclose the IOI to HUD and attempt to obtain HUD's written approval of the IOI before continuing; or in the alternative, the MAP Lender may undertake one of the following measures:
  - a. transfer the transaction to the traditional application processing program. The Regional or Satellite Office must completely reprocess all stages of the transaction; or
  - b. transfer the project to a new MAP Lender. The new MAP Lender may be required by the Regional or Satellite Office to reprocess all or some stages of the transaction. At no time prior to final endorsement can the new MAP Lender assign the pre-application submission, the firm commitment application, the mortgage insurance commitment, or the insured loan back to the IOI MAP Lender.
  
4. **IOI Discovered After Firm Commitment.** Such IOIs may reflect either a lack of transparency, absence of due diligence, or negligence on the part of the MAP Lender. The MAP Lender, and other involved parties, may be referred to investigative or enforcement authorities. The Regional or Satellite Office must refer such transactions to MACOD.

## **G. Certification.**

There are three exceptions when certification is not required: loan advances made in accordance with Program Obligations; notes given to evidence additional financing charges owed by Borrower to the MAP Lender as authorized in the MAP Guide and as disclosed pursuant to section (20)(h) of the Lender's Certificate (HUD-92434M or later designation) or section 21(f) of the Certificate of Lender contained in the Request for Endorsement of Credit Instrument (HUD-92455M or later designation), as applicable; or lender advances made pursuant to the Security Instrument (HUD-94000M or later designation). In all other circumstances, the MAP Lender must certify and agree that it:

1. does not have outstanding loans or advances to the Borrower's Team, any of the sponsors, the general contractor, or the architect for any purpose directly or indirectly related to the MAP loan without prior written approval of HUD;
2. will not make any loans or advances to the aforementioned parties;
3. has not made or offered, and shall not make or offer, any guarantees, pledges, reservations of sums to become due, or other inducements to any entity or person associated with the MAP loan.

## **H. IOI Tax Credit Equity Syndicator or Investor Representation and Warranty.**

The affiliated tax credit equity syndicator or investor must not improperly influence the MAP Lender on a LIHTC project. The MAP Lender and the affiliated tax credit equity syndicator or investor must each provide the Regional or Satellite Office a specific Representation and Warranty on each application submitted for a LIHTC project, which contains the following criminal warning language:

1. The MAP Lender's Representation and Warranty must state:
  - a. With respect to any LIHTC project loan that it will process under MAP:
    - (1) No officer or employee of \_\_\_\_\_ (insert the name of the affiliated tax credit equity syndicator or investor) or any director or parent thereof will have any loan-specific or decision making control or influence in \_\_\_\_\_'s (insert the name of MAP Lender) underwriting of the MAP loan except by providing factual information to \_\_\_\_\_ (insert the name of MAP Lender) in the same manner as would be provided by an unaffiliated syndicator).
    - (2) \_\_\_\_\_ (insert name of MAP Lender) will not condition its agreement to provide such financing on \_\_\_\_\_ (insert the name of affiliated tax credit equity syndicator or investor) being selected as the tax credit equity syndicator or investor for the project to be financed by the MAP loan.

- b. \_\_\_\_\_ (insert the name of MAP Lender) will notify HUD promptly, in writing, during application processing of any change or event which causes the foregoing Representation or Warranty to be materially untrue or inaccurate.
  - c. **WARNING:** *“HUD will prosecute false claims and statements. Convictions may result and/or civil penalties. (18 U.S.C. 1001, 1010, 1012; 31 U.S.C. 3729, 3802).”*
2. The MAP Lender’s affiliated tax credit equity syndicator or investor’s Representation and Warranty must state:
- a. In the regular course of its business it syndicates or invests in tax credit equity investments in multifamily affordable housing projects.
  - b. With respect to any project loan that is to be underwritten by \_\_\_\_\_ (insert name of MAP Lender) and in which \_\_\_\_\_ (insert name of affiliated tax credit equity syndicator or investor) intends to make an equity investment or sell equity to other investors:
    - (1) No officer or employee \_\_\_\_\_ (insert name of MAP Lender) will have any loan-specific control or influence in \_\_\_\_\_’s (insert name of affiliated tax credit equity syndicator or investor) processing of the sponsor’s application for tax credit equity syndication or investment except by providing factual information to \_\_\_\_\_ (insert the name of affiliated tax credit equity syndicator or investor) in the same manner as would be provided to an unaffiliated MAP Lender.
    - (2) \_\_\_\_\_ (insert the name of affiliated tax credit equity syndicator or investor) will not condition its commitment to syndicate or invest in the project equity on debt financing for such a project being provided by \_\_\_\_\_ (insert name of MAP Lender).
    - (3) Except during the interim period prior to the placed in service date during which \_\_\_\_\_ (insert name of affiliated tax credit equity syndicator or investor) may make an equity bridge loan to the project, neither \_\_\_\_\_ (insert the name of affiliated tax credit equity syndicator or investor) nor any affiliate or subsidiary thereof will hold greater than a 25 percent interest in the 99 percent investor limited partnership entity (or an equivalent percentage if owned as an LLC) of the borrower.
  - c. **WARNING:** *“HUD will prosecute false claims and statements. Convictions may result and/or civil penalties. (18 U.S.C. 1001, 1010, 1012; 31 U.S.C. 3729, 3802).”*

## 2.8 MAP Lender Application Package

The Lender’s application should include one hard copy and an electronic version. There is no specific required application form for approval as a MAP Lender, but the information submitted must include the following:

- A. Exhibit A. Name of applicant, address, employer identification number, contact person or persons, telephone and fax number, e-mail address, branch offices for multifamily business with address, telephone and e-mail address, and the FHA Mortgagee ID Number.
- B. Exhibit B. List of names and titles of those who are authorized to bind the lender in matters involving an application, underwriting and origination of insured mortgages under MAP.
- C. Exhibit C. Type of FHA-Mortgagee (e.g., supervised or non-supervised), type of legal structure (e.g., general corporation, limited liability corporation, partnership, housing finance agency or other), whether the Lender is a subsidiary of another company, and if so, identification of the parent company.
- D. Exhibit D. Copy of most recent financial statements submitted to HQ Lender Approval Division (not applicable to supervised mortgagees).
- E. Exhibit E. Narrative discussion of the applicant's method of operation in multifamily lending. This will include whether it: a) services loans, b) is an originator that sells commitments or loans to others, c) originates and holds loans in its portfolio; d) purchases loans from others and e) has experience in construction loan administration. Also include the number, location and staffing of branch offices it operates, any other information the applicant deems relevant in providing a clear description of its business.
- F. Exhibit F. Experience of the Lender in multifamily loan origination, for both conventional and FHA insured loans. List the FHA insured loans for which Lender has received Firm Commitments in the last five years and the number, name, location, original amount, HUD Office where processed and whether the loan is in default has been assigned, or an election to assign the loan to FHA has been filed, or the Lender has elected to foreclose on the loan. The extent of conventional lending may be summarized rather than listing each conventional mortgage originated in the last five years. It is important to summarize the extent of conventional multifamily experience, the extent to which construction loan administration was involved and the number and percentage of defaults and foreclosures. List any FHA or conventional loan that was sold since origination and is serviced by another lender. Report on whether the sold loan is in default, foreclosure or has been assigned to FHA. Default for these purposes means a loan whose payment is more than 60 days overdue.
- G. Exhibit G. Narrative discussion explaining any elections to assign FHA loans for insurance benefits for any Initial Endorsements that occurred after May 1, 1995.
- H. Exhibit H. Resumes of the staff that will be responsible for the submission of MAP loan applications, which demonstrate that the staff has the required multifamily experience.
- I. Exhibit I. Experience in construction loan administration, if intending to perform this function. Identify those persons authorized to sign advances, construction change orders and escrow releases.
- J. Exhibit J. Information regarding:

1. Lawsuits/claims/judgments filed or issued in the last three years against the applicant which:
    - a. Concern equal employment or lender discrimination prohibited by law, or
    - b. Are a result of, or might significantly affect, its multifamily lending business.
  2. Any criminal or civil charges brought against the applicant related to the mortgage lending business.
- K. Exhibit K. Certification by the Lender that it will certify with each pre-application submission and application for mortgage insurance that it is in compliance with the identity-of-interest provisions in the MAP Guide.
- L. Exhibit L. An agreement that the Lender will open its files and records on FHA applications for monitoring by HUD staff, including by the Multifamily Asset Counterparty Oversight Division and the Office of Inspector General.
- M. Exhibit M. A Quality Control Plan for underwriting and construction loan administration, if applicable, of insured mortgages processed under MAP.
- N. Exhibit N. Copy of Letter of Approval/HUD approval, Form HUD-92001-B, Branch Office Notification Title I/ Title II, evidencing approval as an FHA Approved Multifamily Mortgagee.

## **2.9 Limitation on Requirements**

- A. There are no additional capital requirements for MAP Lenders beyond the Department's minimum net worth and liquidity requirements in 24 CFR Part 202.
- B. There is no fee required by HUD for qualifying a MAP Lender.
- C. MAP Lenders need to promptly notify the Multifamily Asset Counterparty Oversight Division if there has been a change in approved signatories. MAP Lenders are expected to maintain at all times the staff with the level of experience and qualifications required by this MAP Guide. Other than Underwriters, Chief Underwriters (and Deputy Chief Underwriters), Construction Analyst, and Administrators, the Multifamily Asset Counterparty Oversight Division will not approve or disapprove of individuals working for MAP Lenders.
- D. MAP Lenders must notify the Multifamily Asset Counterparty Oversight Division if there has been a change of address of the home office for multifamily business, electronic mail address or telephone number. If there is a change in ownership or if the lender has a material change in its way of doing business, the lender must re-apply for MAP Lender status. If there is a change in the MAP Lender's name or in the name the Lender does business as (DBA), with no other substantive changes proposed, the Lender must notify HUD of the change. The Lender must also include a certification that there has been no change in ownership, principal staff or in the lender's quality control plan and procedures. Lenders must also notify the Multifamily Asset Counterparty Oversight Division if they withdraw as MAP Lenders, even if temporarily.

## **2.10 Monitoring by Multifamily Asset Counterparty Oversight Division**

The applicant for MAP Lender approval agrees that it will make its files and records available to HUD or HUD's authorized contractors for such monitoring of MAP processed loans as HUD determines. The Lender must retain the origination and underwriting files for seven years after Final Endorsement (even if the loan has been sold.)

- A. MAP Lenders are subject to monitoring and periodic on-site reviews by the Multifamily Asset Counterparty Oversight Division to verify that the Lender(s):
  - 1. adheres to all statutory, regulatory and MAP Guide requirements;
  - 2. underwriting decisions are consistent with the requirements of the MAP Guide;
  - 3. technical processing is consistent with the requirements of the MAP Guide;
  - 4. has complied with the conditions of the Firm Commitment and the requirements for Initial or Final Endorsement; and
  - 5. has complied with the requirements for construction loan administration in the MAP Guide.
- B. The Multifamily Asset Counterparty Oversight Division will not commence reviews of origination and underwriting documentation until after the Lender's first MAP Firm Commitment has been issued. Please note that the Multifamily Asset Counterparty Oversight Division reserves the right to review any loans.
- C. If a MAP Lender, or an authorized employee or agent of the Lender acting under the control and supervision of the Lender, violates any program requirement including, but not limited to, committing fraud, misrepresentation, or any violation described at 24 C.F.R. §§ 25.6 and 30.35(a), HUD reserves its rights to initiate all legal action available to it under the law, including without limitation action against the Lender under the contract of mortgage insurance and Mortgagee Review Board requirements.
- D. The review by the Multifamily Asset Counterparty Oversight Division is not a substitute for other periodic audits and reviews by HUD, including a financial management review and a review of the Lender's quality control plan as required by HUD Handbook 4060.1 "Mortgagee Approval Handbook." Multifamily Production and other offices within HUD may perform monitoring reviews.

## **2.11 MAP Underwriter Approval Standards**

MAP Lenders must have MAP-approved Underwriters working on the transactions submitted to HUD. MAP Underwriters must be approved either by HUD or by a HUD-approved Chief Underwriter that is employed by a MAP Lender. The process for certifying MAP Underwriters under both the traditional model and the Chief Underwriter model are outlined below.

HUD will continue to approve MAP Underwriters for: currently approved Low Volume MAP Lenders (less than a four-year trailing average of \$100,000,000 in firm commitments annually) that choose not to

participate in the Chief Underwriting model, new MAP Lenders with less than 4-years MAP underwriting experience (until they attain sufficient experience), and MAP Lenders with suspension or termination enforcement actions within the previous four years. All other MAP Lenders must approve their MAP junior underwriting staff pursuant to the Chief Underwriter process set forth further below.

HUD reserves the right to withhold or condition approval authority for MAP Underwriters. The basis for Underwriter rejections or conditions to approval will be in writing. Lenders may appeal rejections or conditions to approval to the Deputy Assistant Secretary for Multifamily Housing Programs. Staff not involved in the original decision will review and respond to the appeal.

**A. MAP Underwriter.** A MAP Underwriter must be a full time salaried employee of the MAP Lender. The Underwriter cannot be hired on a contract basis for a particular loan application. Underwriter compensation cannot be based on loan production volume, nor may the underwriter be compensated in a way that may be construed as a means of discouraging prudent risk management. Applicants for MAP Underwriter designation may range from trainees to veteran executives with years of experience; all are expected to document they have met the minimum education and experience requirements expected of Underwriter trainees. The applicant must demonstrate competence and the following qualifications:

1. **Requirements:** The applicant must have knowledge and skills in a variety of financial areas, including:
  - a. General experience in banking, accounting, finance, commercial lending, and in multifamily mortgage financing.
  - b. The ability to analyze corporate and personal financial statements including, but not limited to, balance sheets, income statements, and statements of changes in financial position and to evaluate the credit acceptability of individuals, partnerships, corporations, and other entities.
  - c. A broad knowledge of lending practices for mortgages and construction loans and the financial structures of individuals, partnerships, and other business entities.
  - d. The applicant must demonstrate recent, like-kind underwriting experience. Recent experience shall be defined as actual underwriting experience obtained by underwriting a funded multifamily loan within the previous 5 years. Like-kind experience shall be defined as underwriting with comparable duties and responsibilities as required under the MAP program.
2. **Application for HUD Approval of MAP Underwriters:** One paper copy and a complete electronic version of the application are to be included with the submission. One copy of the written request for approval should be submitted by a senior officer of the MAP Lender with signatory authority to HUD and include the following exhibits:
  - a. Resume of the Underwriter that demonstrates the specific qualifications, education and the level of experience.

- b. Documentation of successful completion of relevant education, and a HUD MAP training certificate (or request for conditional approval to allow deferral of the MAP training certificate).
- c. List of loans (MAP and otherwise) processed and underwritten by the Underwriter that reached Firm Commitment, certified and signed by a senior officer with authorized signatory designation and by the underwriter applicant. The list must contain the following warning code:

**Warning:** *Title 18 U.S.C. 1001, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any manner in the jurisdiction of any department or agency of the United States, shall be fined not more than \$10,000 or imprisoned for not more than five years or both.*

- d. Additional supporting documentation may be requested by HUD.

**B. Chief Underwriter.** MAP Lenders that are responsible for approving their MAP Underwriters pursuant to Section 2.11.A above must designate an employee as a Chief Underwriter that is HUD-approved. The designated Chief Underwriter will have delegated responsibility for approving MAP Underwriters and Deputy Chief Underwriters. The Chief Underwriter must certify that the MAP Underwriter or Deputy Chief Underwriter is qualified according to MAP Guide requirements.

Ongoing eligibility to approve Underwriters will be determined by MACOD, by confirming the following: the MAP Lender is in good standing; the Chief and Deputy Chief Underwriters are in good standing; the Chief Underwriter or Deputy has co-signed each application submitted by a designated underwriter; and the Chief Underwriter asserts in their annual certification that their Quality Control plan and underwriting staff are in compliance as defined herein.

**1. Requirements:**

- a. The proposed Chief Underwriter must be approved, in writing, by HUD.
- b. The proposed Chief Underwriter must be in good standing with the Department and in full MAP compliance, defined as not been subjected to MAP disciplinary actions (probation, suspension or termination), over the previous four (4) years.
- c. The proposed Chief Underwriter must have evidence of ten (10) years prior underwriting experience. The experience must include a minimum of five (5) years FHA/MAP underwriting experience, with the remaining experience to be comprised of Ginnie Mae / Fannie Mae / Freddie Mac, Risk Sharing, or other like-kind underwriting experience. The

experience need not be continuous, but must total 10 years. The proposed Chief Underwriter's application must include a listing of FHA loans underwritten and the name(s) of the submitting Lender. At HUD's discretion, the individual may request that 1-year's equivalent experience be granted for evidence of each 10 acceptably processed Firm Commitment applications, for up to 5 years' experience.

- d. The proposed Chief Underwriter must demonstrate experience in the training, development and oversight of Underwriter trainees. The application should include specific experience with a list of all personnel trained.
- e. The proposed Chief Underwriter may not hold a significant equity position, in or be a principal of, the lender or any of the lender's affiliates. Employee Stock Ownership Plans and similar forms of compensation are permissible.

## **2. Roles and Responsibilities:**

- a. Creation and oversight of the MAP Lender's training and development program for underwriting personnel.
- b. Approving MAP Underwriters.
- c. The MAP Lender's compliance with statutory, regulatory and programmatic underwriting processes, requirements and standards.
- d. Establishment and oversight of the MAP Lender's Quality Control Process.
- e. Reviewing, approving and cosigning all HUD mortgage insurance applications. Submissions must be cosigned by the Chief Underwriter.
- f. The Chief Underwriter may delegate responsibilities to the Deputy Chief Underwriter, but the Chief Underwriter remains responsible.
- g. Implementation of HUD recommended opportunities for improvement, to include findings and observations gleaned from MAP Lender or property loan reviews.

## **3. MAP Underwriter Approval Process and Certification.**

- a. **Approval.** The MAP Lender and Chief Underwriter must provide a certification that the MAP Underwriter or the Underwriter Trainee has complied with all experience and training requirements detailed in this Guide. The MAP Lender and Chief Underwriter must evaluate the prospective underwriter to ensure and commit to the following:
  - (1) Underwriter has completed and complied with the MAP Lender's approved training plan.

(2) Chief Underwriter has extensively reviewed the Underwriter Trainee's underwriting during the training period to ensure it complies with the MAP requirements, as well as accurately represents the risk associated with the proposed loan.

(3) The Chief Underwriter has reviewed and ensured loan documentation submitted to HUD during the training period was complete, and that the submission did not require significant revision by HUD staff to correct errors or omissions.

b. **Authorization.** The MAP Lender and Chief Underwriter shall immediately notify HUD and certify that the Underwriter or the Underwriter Trainee has satisfactorily completed the Designation Criteria, and has been approved and designated to underwrite loans. The designee is not authorized to begin underwriting until HUD is in receipt and acknowledges the MAP Lender's notification and certification.

c. **Rescinding Approval.** Although HUD will rely upon designation and certification by the MAP Lender, HUD reserves the right, with due cause and written notification, to deny or rescind such approval, and otherwise hold the MAP Chief Underwriter accountable under any of the following circumstances:

(1) Evidence that the Underwriter Trainee's work product during the training period was unsatisfactory.

(2) Prior incidences of poor underwriting that display a lack of knowledge or failure to exercise prudent judgment.

(3) The Underwriter Trainee is listed on HUD's LDP or debarment list.

(4) For other good cause.

d. **Quality Control Reviews.** Quality Control (QC) reviews prepared by the MAP Lender must include confirmation that the Chief Underwriter and the Underwriter(s) are approved and have satisfactorily completed all Designation Criteria, including, without limitation, the MAP Lender's approved training and approval requirements. During the Quality Control process, the reviewer will ensure that each loan reviewed was underwritten by an approved and designated Underwriter, and, if the Underwriter was approved within the previous four years, the QC review should include a review of the Underwriter's approval package.

C. **Deputy Chief Underwriter.** The MAP Lender's Deputy Chief Underwriter can perform all functions delegated to the MAP Lender's Chief Underwriter, but the Chief Underwriter remains responsible for all actions of the Deputy Chief Underwriter. With notice to and approval by HUD, the Deputy Chief Underwriter can also act as an interim Chief Underwriter to maintain business continuity in emergency situations. In such an event, the MAP Lender must obtain HUD approval for the Deputy Chief Underwriter to act for the Chief Underwriter if that person does so for more

than 3 months or for a replacement Chief Underwriter within 6 months of the MAP Lender's initial notification to HUD.

**1. Requirements:**

- a. The proposed Deputy Chief Underwriter must be approved, in writing, by HUD.
- b. The proposed Deputy Chief Underwriter must be in good standing with the Department and in full MAP compliance, defined as not been subjected to MAP disciplinary actions (probation, suspension or termination), over the previous four (4) years.
- c. The proposed Deputy Chief Underwriter must provide evidence of five (5) years prior underwriting experience. The underwriter's experience should include a minimum of three (3) years FHA/MAP underwriting experience, with the remaining experience to be comprised of Ginnie Mae / Fannie Mae / Freddie Mac, Risk Sharing, or other like-kind underwriting experience. The experience need not be continuous, but must total five (5) years. The proposed Deputy Chief Underwriter's application must include a listing of FHA loans underwritten and the name(s) of the submitting lender. At HUD's discretion, the underwriter may request that 1-year's equivalent experience be granted for evidence of each 10 acceptably processed Firm Commitment applications.
- d. The proposed Deputy Chief Underwriter may not hold a significant equity position, in or be a principal of, the lender or any of the lender's affiliates. Employee Stock Ownership Plans and similar forms of compensation are permissible.
- e. Large MAP Lenders may designate more than one Deputy Chief Underwriter.

## **2.12 MAP Lender Underwriter Trainee Approval Requirements**

An approved MAP Lender may train its in-house staff to be new MAP Underwriters. The lender must establish a written development plan for underwriter trainees that include a combination of commercial/multifamily training courses and on the job experience.

- A. The Underwriter trainee must have successfully completed at least three underwriting, finance, appraisal or environmental courses that demonstrate basic understanding of multifamily underwriting concepts, one of which must be a multifamily/ commercial appraisal course. These courses may be obtained through the American Bankers Association, Institute of Real Estate Management, National Association of the Review Appraisers & Mortgage Underwriters, the Mortgage Bankers Association of America (MBA), the Appraisal Institute or any other acceptable training institution such as colleges and universities. Suggested courses include *Commercial Underwriting*, *Understand Your Construction Borrower*, *Analyzing Financial Statements*,

*Commercial Real Estate Financing and Valuation, Appraisal: Concepts and Applications, Appraisal Principles, Appraisal Procedures, Basic Income Capitalization, Advanced Income Capitalization, Uniform Standards of Professional Appraisal Practice (USPAP).*

Education used to meet Underwriter approval requirements must be comprehensive enough to provide substantive background. In-depth specialized technical training provided by recognized training institutions, trade associations, or private firms will be considered so long as the content and duration of the class is analogous to a college level class. One day seminars or participation in industry conferences are appropriate (and expected) for continuing education, but not sufficient to meet the requirement for one of the three courses. Lenders or training providers may submit a course syllabus to the Director of the Multifamily Asset Counterparty Oversight Division if they have a question as to the sufficiency of a particular course to meet the requirement.

- B. In addition to the training courses, HUD requires on the job training of a minimum of three years continuous work experience in multifamily mortgage lending. The Underwriter trainee must work on a minimum of three MAP applications that reach Firm Commitment. Only one Underwriter trainee may assist the MAP approved Underwriter in completion of any MAP application which should document that the trainee was supervised by only one mentor MAP approved Underwriter.
- C. The MAP approved Underwriter and the trainee must sign the Narrative Summary and the processing forms. An Underwriter trainee may assist the underwriter in completion of the underwriting.
- D. The MAP approved Underwriter must accept responsibility for all aspects of the underwriting of the transaction as evidenced by the Narrative Summary and processing forms.
- E. The Underwriter trainee must be a full time salaried employee of the MAP Lender. The trainee cannot be hired on a contract basis for a particular loan application.
- F. The trainee's contribution and the specific tasks performed by the trainee should be stated in the Narrative Summary.
- G. Work completed by an Underwriter trainee must be under the direct supervision of the MAP approved Underwriter and it is unacceptable for the underwriter to merely sign a form or document prepared by a trainee without providing proper supervision. The mentor Underwriter must add a paragraph in the Underwriter Certification to certify that he/ she has directly supervised the underwriter trainee in completion of the specific tasks in the underwriting narrative and the processing forms.
- H. One hard copy of the written request for approval should be submitted by a senior officer of the MAP Lender with signatory authority to HUD and include the following exhibits. The application should also include an electronic version.

- I. A written development plan must be established for the Underwriter trainee, and submitted with the application.
- J. The application should include a resume of the Underwriter trainee that demonstrates the specific qualifications, education and the level of experience outlined above and a HUD MAP training certificate.
- K. The application should include a list of MAP loans processed and underwritten by the trainee that reached Firm Commitment, certified and signed by a senior officer with authorized signatory designation and by the Underwriter trainee. The list must contain the following warning code:

**Warning:** *Title 18 U.S.C. 1001, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any manner in the jurisdiction of any department or agency of the United States, shall be fined not more than \$10,000 or imprisoned for not more than five years or both.*

- L. The application should include an electronic submission of complete documentation of each MAP transaction application. The documentation signed by the trainee and co-signed by the mentor underwriter must include:
  - 1. A copy of Underwriter's Narrative that clearly identifies the specific tasks performed by the underwriter trainee.
  - 2. A copy of completed Form HUD-92264-A and other forms and / or exhibits for the type of mortgage proposed that require a mortgage credit analysis. (Refer to Chapter 8 and Appendix 4)
  - 3. A copy of the Master HUD-92264.
  - 4. An Identity of Interest Certification as required by Section 11.2.F, signed and dated by the Underwriter trainee only.

A hard copy of the MAP transaction application is not required and should not be submitted.

- M. Underwriter candidates that have successfully completed the MBA's six month FHA Multifamily underwriting course will receive credit toward the experience and education requirements. Completion of that course will:
  - 1. fully satisfy the requirement to complete three courses;
  - 2. fully satisfy the requirement to complete a MAP training course;
  - 3. satisfy half of the three transactions requirement; and,
  - 4. satisfy half of the three years of experience requirement.

In satisfying half of the FHA MAP Underwriter requirements in #3 and #4 above, the candidate may elect to utilize the course completion to fulfill either two transactions/one year, or one transaction/two years of the requirements. The applicant should submit evidence of completion of the MBA MAP Underwriter course, and indicate how to utilize the completion toward the requirements.

## 2.13 MAP Underwriter Transfers

- A. MAP Underwriters that have previously been approved by HUD, and that are in good standing, may apply for transfer to another approved MAP Lender.
- B. Application: One copy of the written request for approval along with an electronic version should be submitted by a senior officer of the MAP Lender with signatory authority to HUD and include the following exhibits.
- C. The application should include:
  - 1. Resume of the underwriter that demonstrates the specific qualifications, education and the level of experience.
  - 2. Evidence of prior MAP Underwriter approval.
  - 3. Most recent HUD MAP training certificate.
  - 4. List of MAP loans processed and underwritten by the underwriter that reached Firm Commitment, certified and signed by a senior officer with authorized signatory designation and by the underwriter applicant. The list must contain the following warning code:

**Warning:** *Title 18 U.S.C. 1001, provides in part that whoever knowingly and willfully makes or uses a document containing any false, fictitious, or fraudulent statement or entry, in any manner in the jurisdiction of any department or agency of the United States, shall be fined not more than \$10,000 or imprisoned for not more than five years or both.*
  - 5. A detailed list of all prior MAP loan assignments in which the Underwriter was affiliated with, to include a detail of the claim's circumstances and any mitigations applicable.

## 3.1 General Program Requirements

This chapter contains the basic requirements for FHA multifamily mortgage insurance programs for which lenders can submit Pre-applications and applications for Firm Commitment under MAP.

The following requirements apply to *all* FHA multifamily mortgage insurance programs:

- A. **Regulatory Agreement.** All borrowers must execute a HUD Regulatory Agreement governing the operation of the project. The Regulatory Agreement is recorded at Initial Endorsement.
- B. **Single Asset Mortgagor Entity.** The mortgaged property must be the only asset of the borrower entity and there may not be more than one borrower entity. Natural persons or Tenants-in-Common ownership structures (including entities such as Delaware Statutory Trusts) are not permitted as mortgagor entities, though they may hold “upper-tier” interests (i.e., they may have an ownership stake, such as a partnership interest, in the Single Asset Mortgagor Entity,). Waiver authority is reserved for the Director, Office of Multifamily Production HQ and must be obtained prior to a Multifamily Regional Center or Satellite Office accepting an application for mortgage insurance which does not conform to these prohibitions.
- C. **Non-recourse.** The HUD mortgage note will contain a non-recourse provision as to the mortgagor entity. Notwithstanding this provision, certain parties may be held personally liable to the extent of losses arising from certain “bad acts” and malfeasance, as set forth in the Regulatory Agreement. Such parties will be identified in the Firm Commitment.
- D. **Interest rate.** The interest rate on a HUD insured loan is negotiated between the borrower, and the mortgagee (and if applicable, the Ginnie Mae investor) and must be locked in by the time of Initial Endorsement. Payment of discounts by the mortgagor to buy down an interest rate is acceptable during negotiations prior to Initial Endorsement. Any change in the mortgage amount due to a change in interest rate must be reflected in an amendment to the Firm Commitment before Initial Endorsement, and may require an additional loan approval. The Mortgage Note, HUD-94001M, provides for the same or different interest rates for the construction and permanent financing periods.
- E. **Amortization plan.** All HUD insured mortgages must amortize through a level annuity monthly payment plan (LAMP), with equal monthly payments of principal and interest. Other variations are

not permissible. This restriction does not prevent tranches within promissory notes (e.g. A and B pieces).

**F. Loan Terms.** The maximum loan term is the lesser of any limits included under the applicable Section of the Act, 40 years for new construction/substantial rehabilitation, 35 years for Section 223(f) purchase/refinancing, or 75% of the remaining economic life of the property.

**G. Prepayment Restrictions.** The Section 223(f) program limits prepayment during the first five years of the loan. For other Sections of the Act, HUD permits but does not impose, prepayment restrictions on insured loans. Prepayment restriction provisions cannot include HUD consent as a condition to prepayment of the loan by the borrower.

**H. HUD application fee.** Under MAP (and the Section 213 program), HUD requires a fee of \$3 per thousand dollars of the requested mortgage amount for review of the Firm Commitment application. The application fee (also known as “exam fee”) is considered earned at HUD acceptance of the application for processing and is nonrefundable. For market rate new construction or substantial rehabilitation transactions, one half of the application fee is due with the submission of the pre-application package and the other half is due with the application for Firm Commitment. For affordable new construction or substantial rehabilitation proposals and for any refinancing or acquisition transactions, the entire amount is paid at the Firm Commitment stage.

For Section 223(a)(7) transactions processed under MAP (whether or not there is an Identity of Interest between the borrower and lender), the application fee is \$1.50 per thousand dollars of the requested mortgage amount.

For Traditional Application Processing (TAP) loans, the application fee is \$5 per thousand dollars of the requested mortgage amount for market rate transactions and \$3 per thousand dollars of requested mortgage amount if the transaction meets HUD’s definition as Affordable housing or is a Section 223(a)(7) loan processed TAP rather than under MAP.

**I. HUD inspection fee.** The HUD inspection fee is \$5 per thousand of the mortgage amount for new construction and \$5 per thousand of improvement costs for substantial rehabilitation. There is no inspection fee for Section 223(a)(7) projects (even if there are repairs). For loans insured pursuant to Section 207/223(f), the inspection fee is the following:

1. \$30 per unit where the repairs/improvements are greater than \$100,000 in total but \$3,000 or less per unit.
2. The greater of \$30 per unit or 1% of the cost of repairs or \$1,500, where the repairs/improvements are more than \$3,000 per unit.

3. \$1,500 where the total repairs/improvements are less than \$100,000, which may be decreased by the Regional Center or Satellite Office, if the lender elects to take responsibility for the inspection.

**J. Mortgage insurance premium.** The mortgage insurance premiums are established by the Firm Commitment and may not be changed after initial endorsement. The construction period and annual mortgage insurance premiums (MIP) are based on a percentage of the mortgage amount and may vary, depending on the insurance program and on the MIP schedule posted by HUD each fiscal year.

The initial premium is payable in advance at initial endorsement. Unless revised in a Federal Register Notice, this “up front” premium is the same for all market rate and affordable refinancing transactions:

- 1% for Section 223(f) loans,
- ½% (50 basis points) for Section 223(a)(7) loans, and
- New Construction or Substantial Rehabilitation loans include a capitalized mortgage insurance premium based on the mortgage amount and the number of years (including a portion of a year) of the estimated construction or rehabilitation period.

**K. Lender fees and charges.** For programs other than Section 223(a)(7), the maximum financing and placement fees the lender may charge is limited to a total of 3.5% of the mortgage amount. This 3.5% maximum can consist of any combination of origination, financing, and permanent placement fees as long as it also includes the lender’s legal fee. Financing and placement fees up to 5.5% are permissible in bond transactions. Third party costs (e.g., appraisal, market study, CNA, and other organization costs) may be included as mortgageable soft costs in the mortgage calculations, and are not included in the limitation on lender fees. See Section 11.5 for additional provisions regarding loan fees and charges.

The lender is prohibited from advancing fees for payment of discount fees on behalf of the borrower. Waivers of this provision must be granted in writing by HUD Headquarters.

**L. Definition of Affordable Housing.** Affordable housing in the context of FHA multifamily mortgage insurance programs is defined as projects meeting both of the following requirements:

1. Rent and income restrictions must be imposed, monitored and enforced by a governmental agency for at least 15 years after Final Endorsement, and
2. Either
  - (a) a recorded Regulatory Agreement requiring the project to meet at least the minimum LIHTC restrictions of 20% of units at 50% of area median income (AMI), or 40% of units

- at 60% of AMI, with economic rents (i.e. the portion paid by the residents) on those units no greater than LIHTC rents, or
- (b) a Project-Based Section 8 contract for 90% of the units.

Projects need not use LIHTCs to qualify for affordable underwriting so long as they meet the above requirements.

**M. Fair Housing and Equal Opportunity.** Borrowers, management agents, contractors and subcontractors must comply with HUD Fair Housing and Equal Opportunity requirements. Such requirements include selection of occupants, employment, and project accessibility (See 24 CFR Part 100 and subsequent Sections), regardless of race, color, nationality/ethnicity, religion, sex, disability and familial status (children of all ages and pregnant women) which are all Fair Housing Act protected classes. Discrimination by age is also prohibited and the Equal Access Rule (24 CFR 5.105(a)(2)) provides for non-discrimination based on actual or perceived sexual orientation, gender identity or marital status.

Affirmative Fair Housing Marketing requirements are addressed in Section 10.9 of this Guide. Also see “Affirmative Fair Housing Marketing to Fair Housing Act Protected Classes” (24 CFR Part 200.600 and Handbook 8025.1 Revision 2), and “Nondiscrimination Based on Handicap in Federally Assisted Programs and Activities of the Department of Housing and Urban Development” (24 CFR Part 8).

Fair Housing violations may result in enforcement actions including but not limited to Limited Denial of Participation.

**N. Previous Participation.** Individuals and entities in control of a project are subject to a previous participation review as set forth in 24 C.F.R. Part 200, as the same may be amended from time to time, and must submit information regarding previous participation in governmental housing transactions either via the electronic Active Partner Participation System (APPS) or on Form HUD-2530, or any successor system or form, for approval for participation in any mortgage insurance program. Invitation Letters or Firm Commitments may be issued conditioned on Previous Participation approval, assuming no critical findings and that any flags can be resolved without being presented to the Multifamily Participation Review Committee.

## O. Elderly or Age Restricted Housing and Fair Housing Act Occupancy Requirements

General eligibility requirements.

1. For FHA Multifamily mortgage insurance programs. In order to be eligible for FHA mortgage insurance, properties proposing to restrict occupancy to elderly families or elderly persons must comply with one of the following three occupancy categories:

A. Statutorily authorized occupancy restrictions, including authorized programs in which the head of household (HOH) is 62 years of age or over (“62+ HOH”). Properties proposing to restrict occupancy to certain populations pursuant to specific statutory authority may be eligible for FHA mortgage insurance. This category includes, without limitation, properties operating under programs in which, pursuant to statutory authority, HUD has approved restricting occupancy to a “mixed use” population including elderly and non-elderly disabled families. Section 231 is one such program. This category also includes, without limitation, properties restricting occupancy in accordance with statutory authority provided under Sections 221 or 236 of the National Housing Act or Section 8 of the United States Housing Act of 1937. Several of these programs authorize properties to restrict occupancy to households in which at least one person is 62 years old and which may include children under the age of 18. This is FHA’s long standing definition of elderly families and has been referred to in previous FHA guidance as “62+ HOH”. A property operating under this design cannot discriminate against elderly families with children in its admission and occupancy policies. If a program has statutory authorization for a specific kind of occupancy restriction, an exemption from the Fair Housing Act’s familial status provisions is not needed to operate the property in accordance with that program.

B. Housing primarily for persons age 55 and older. (55+ Exemption). HUD does not permit projects with occupancy restricted to age 55 and older under any multifamily New Construction programs. Existing properties that restrict occupancy to households in which at least one person is at least 55 years old may be eligible for FHA mortgage insurance for refinancing or acquisition financing if they qualify for an exemption from the familial status provisions of the Fair Housing Act and the program complies with all requirements set forth at Section 3.1.O.2.B below. To qualify as housing “intended and operated for occupancy by persons 55 years of age or older,” the housing provider must meet all three of the following criteria:

- i) at least 80 percent of the occupied units are occupied by at least one person who is 55 years of age or older;
- ii) the housing community or facility publishes and adheres to policies and procedures that demonstrate the intent to serve persons 55 years of age and older; and
- iii) the housing facility or community complies with the rules issued by HUD for verification of occupancy.

42 U.S.C. § 3607(B)(2)(C)(i)-(iii). HUD's implementing regulations at 24 C.F.R. part 100 address these three requirements in greater detail: the 80 percent minimum occupancy requirement outlined in (i), above is addressed at 24 C.F.R. § 100.305; the assessment of intent outlined in (ii), above is addressed at 24 C.F.R. § 100.306; and the verification requirements outlined in (iii) above are addressed at 24 C.F.R. § 100.307.

Applicable properties must have complied with the Fair Housing Act's conversion rules, including the rule covering properties intending to convert from non-exempt to exempt housing after May 3, 2000. In these projects, the owner/borrower of an existing property must apply neutral admission policies (admitting otherwise head of household age-eligible families with children) until the 80 percent threshold of the exemption is satisfied. For properties constructed after May 3, 2000, the new construction rules dictate that such properties may discriminate against families with children until 25 percent of its units are occupied. Once the 25 percent threshold is reached, at least 80 percent of the occupied units must have a resident who is 55 years of age or older. If the property does not meet the 80 percent requirement once the 25 percent occupation threshold is reached, the owner/borrower may not thereafter exclude or otherwise discriminate against families with children.

The Fair Housing Act prohibits "dual purpose housing facilities." A housing facility or community may not avail itself of the 55 and older exemption if it designates some units, sections or buildings for persons age 55 and older, while designating other units, sections or buildings for families with children. *See* 54 Fed. Reg. 3232, 3252 (January 23, 1989). Furthermore, properties applying for purposes of FHA mortgage insurance must be "one marketable, manageable real estate entity". Any property proposing one FHA insured loan, with separate management agreements and procedures for a portion of the units or buildings restricting occupancy to older persons age 55+ or older and another portion to other occupancy regimes will generally not be considered one manageable entity and thus not eligible for mortgage insurance.

- C. Housing solely for persons age 62 and older. Properties proposing to restrict occupancy exclusively to persons 62 years of age or older may be eligible for FHA mortgage insurance, but only pursuant to the Section 231 program, pursuant to Section 3.1.O.2.C below. Although housing intended for, and solely occupied by, persons 62 years of age or older is a recognized exemption from the familial status provisions of the Fair Housing Act, 42 U.S.C. § 3607(b)(2)(B), it is FHA's policy only to allow this restriction on occupancy for Section 231 transactions. Therefore, this category is available only for Section 231 transactions.

**Note:** Age-related restrictions that are not eligible for FHA mortgage insurance programs. The Fair Housing Act recognizes another exemption from its familial status provisions, namely for housing "provided under any State or Federal program that the Secretary determines is specifically designed and operated to assist elderly persons (as defined in the State or Federal program)" 42 U.S.C. § 3607(b)(2)(A). Although this is a recognized exemption to the Fair Housing Act's familial status protections, it has not heretofore been necessary to rely on this exemption in the context of MAP multifamily insurance processing. Therefore, FHA policy requires a property to fit into one of the other three categories described in this section 3.1.O.1.

2. Additional FHA mortgage insurance requirements applicable to specific project types. This section lists additional requirements relating to proposed age-restrictions for each of the kinds of projects listed.

- A. Market Rate Projects other than those applying under Section 231. For purposes of this section, market rate projects are those applying for New Construction or Substantial Rehabilitation or Acquisition or Refinancing (including Section 213 Cooperative projects), that do not meet the criteria stated in Section 3.1.L. for Affordable projects. Except for projects applying under Section 231, market rate applications for age-restricted projects must have all units head of household 62 years or older, and cannot exclude non-elderly family members including children.
- B. “Affordable” Projects seeking to use the 55+ Exemption under the Fair Housing Act to restrict housing. Projects availing themselves of the 55+ Exemption may be eligible for FHA mortgage insurance if: (i) the project is an affordable property (as defined in Section 3.1.L.); (ii) the project is pursuing FHA mortgage insurance for refinancing or acquisition of existing housing under Section 223(f) or 223(a)(7); (iii) the project is already availing itself of the 55+ Exemption for at least the previous three years and is not using FHA mortgage insurance to facilitate transition into the use of the 55+ Exemption; and (iv) there is no statutory or regulatory restriction limiting eligibility to another category of persons (for example persons or heads of household who are age 62 or older.) Project based Section 8 rental assistance and other assistance have programmatic terms that limit eligibility and thus such projects may not avail themselves of the 55+ Exemption. As a condition of approving FHA mortgage insurance for such projects, the project may be required to document (i) restrictions requiring housing primarily for persons 55 and older, such as through use agreements (LURA or other regulatory agreement) and/or bond documents; (ii) preference points allocated for applications containing such restrictions under qualified allocation plans; or (iii) other affordable properties with externally-imposed restrictions consistent with the 55+ Exemption (e.g., zoning laws, local bonds, and affordable housing trust funds providing preference points for applications containing such restrictions).

These potentially eligible properties must operate in full compliance with the 55+ Exemption in the Fair Housing Act in order to impose age restrictions and exclude children.

Multifamily HUD staff should consult with OGC prior to accepting an application for FHA mortgage insurance for properties operating under the following programs and seeking to take advantage of the 55+ Exemption:

- Old Section 202 Prepaid
- Refinance of Prepaid Section 202

Such properties may or may not be eligible to receive new FHA financing.

- C. Section 231 Projects, including both Market Rate and Affordable projects. Section 231 projects have statutory authority to serve persons who are 62 years old or older as well as statutory authority to serve non-elderly and disabled families. FHA may approve transactions in which up to 25% of the units are available to non-elderly disabled families. See section 3.1.O.1.A. Section 231 projects do not require a specific exemption from the Fair Housing Act because they are statutorily required to provide housing solely to persons who are 62 and over.

### 3. Certifications.

To be eligible for FHA mortgage insurance, a project operating under the 55+ Exemption must provide a Certification of Compliance with the Fair Housing Act by the borrower. A sample template is included in Appendix 3C of this guide. In support of the certification, the borrower must provide the governing age restriction documents and management documents indicating the property complies with the 55+ Exemption. Governing age restriction documents include use agreements, bond documents, tax credit qualified allocation plan and application documents, and zoning documents, as applicable. Management documents include leases, occupancy policies, marketing plans, and affirmative fair housing marketing plans, as applicable. Though such management documents may be sufficient to establish eligibility, processing staff should encourage applicants to provide documents such as use agreements, relevant zoning documents, or bond documents, whenever available. *See* 24 C.F.R. § 100.306 for examples of other relevant documents to be considered.

If an FHA-financing-eligible property certifies as a 55 or older property, it is important for processing staff to verify when the property began operating as such. The regulations, at 24 C.F.R. § 100.305(e), specify that properties had the opportunity to establish eligibility for this exemption until May 3, 2000. After this date, existing projects could avail themselves of this exemption only if they met the criteria defined in sub-option A1 (including the 80 percent threshold) of the certification through neutral admission policies.

### 4. HUD Review Requirements.

HUD processing staff should review the certification to determine whether it is consistent with the age restriction and management documents submitted by the property. Further, processing staff should review the certification, age restriction, and management documents to ensure that the project is not operating as a “dual purpose” property in contravention of the Fair Housing Act.

FHA MAP Lender applications and underwriting must document, and HUD processing staff must verify, the property’s compliance with the Fair Housing Act by requesting and then analyzing the

governing age restriction and management documents to determine whether the documents clearly impose a 55 or older restriction that is compatible with the 55+ Exemption.

5. Services. Projects with extensive service packages or otherwise specifically designed for elderly occupancy such that all or a portion of the units would be eligible under Section 232 of the National Housing Act are not eligible for MAP insurance programs. The following are typical Section 232 project characteristics that are not eligible for multifamily mortgage insurance or MAP processing (whether elderly or non-elderly):
  - a. Projects such as nursing homes, intermediate care facilities, board and care homes, assisted living facilities and day care in eligible health care facilities as defined under Section 232, or projects that contain comparable characteristics.
  - b. Projects in which any percentage of the units must be licensed or regulated by the state or municipality in which the facility is located, other than a standard rental housing occupancy or operating license.
  - c. Projects in which the borrower is required to obtain a Certificate of Need or comparable documentation from the state or municipality.
  - d. Elderly housing developments that provide “continuous protective oversight” services for residents in the manner defined under Section 232.
  - e. Residential accommodations including: a) programmatic restrictions on the number of bedrooms per unit from efficiency through 3 bedroom units, b) non-self-contained units, i.e., a bathroom shared by different residents, or c) a kitchenette or less than what would constitute standard, full kitchen equipment.
  - f. Mandatory resident meal requirements.
  - g. Other resident services made a mandatory condition of occupancy.
  - h. Non-shelter and optional services included in the underwriting of net operating income.

The prohibition on services and licensure discussed in this sub-section does not apply to formerly or currently HUD-held or FHA insured multifamily projects which received Assisted Living Conversion Program Grants for less than 75% of the units.

#### 6. Meals Service Exceptions.

- a. Refinancing HUD insured or HUD assisted properties under Sections 221(d)(4) and 223(f). By final rule published in 56 FR 42798, central kitchens and the provision of food services in elderly housing projects are prohibited under any rental housing section of the National Housing Act, including Sections 223(f) and 221(d)(4). The Regional Center or Satellite Office Director may approve refinancing transactions for properties, with meal services, in refinanced Section 202 and 202/8 direct loan properties, or properties with Project-Based rental assistance which are currently insured under other Sections of the Act, if and only if:

1. Meals were provided before September 30, 1991 (the effective date of the regulation) and have been continuously provided since that date,
2. Meals are provided on an optional basis, or with no more than one mandatory meal per day,
3. Income and expenses from the meal service are not included in the underwriting of net operating income, and
4. The cost of the meals program is self-sustained by the revenue it generates based on HUD's review of the project's financial statements.

b. Non-shelter spaces including formal dining areas with meal services for projects other than those with Project-Based rental assistance and a current Section 202 or HUD-insured loan are not eligible for multifamily mortgage insurance, even if they are provided to residents on an optional basis.

7. Prohibition on Founder's Fees. "Founders' Fees," "admission fees," or similar types of initial occupancy or entry payments are prohibited.

P. **HUD's Fiscal Procedures** are contained in HUD Handbook 4410.1 Revision 2.

Q. **Bridge or Gap Financing.** Bridge financing is a short term loan that is secured by the property or by a pledge of an interest in the borrowing entity, pending the start of a long-term permanent loan. Bridge loans that are secured by the property (as distinguished from bridge loan used to fund equity during construction and which is secured by ownership interests), are acceptable only in instances of Insurance upon Completion and before the start of the FHA-insured permanent financing. Bridge financing is permitted so long as the bridge loan is repaid no later than the time of permanent loan closing (or as otherwise specified in Chapter 14 for Tax Credit projects), or converted in whole or in part to Secondary Financing within the allowed limits for the FHA program. Bridge loan or other debt intended to increase the FHA-insured mortgage or circumvent outstanding program requirements will not be recognized as existing indebtedness in the cost basis. Gap financing is a loan that may be secured by a subordinate lien behind the permanent first mortgage to provide additional capital funds for the project; it must meet the Guide's requirements for secondary financing.

R. **Secondary Financing.** HUD insured mortgages must be first liens. Secondary liens are permitted in the case of HUD insured second mortgages (supplemental loans and operating loss loans) and under certain conditions. Chapter 8 contains the requirements for secondary financing.

S. **Tax Increment Financing.** Tax Increment Financing or TIF, is a public financing method that is used as a subsidy for redevelopment, infrastructure, and other community-improvement projects. States create districts to administer the program for communities to benefit from the TIF. TIF structures vary by municipality, state, or local authority. They may use future gains in taxes (i.e. tax

assessments) to subsidize current improvements. Some States sell bonds backed by a project development's future taxes, while the bond money helps pay the developer's construction costs.

TIF may or may not be recognized as a source of funds, equity, additional income, or a loan in FHA-insured underwriting. The MAP Lender must:

1. Disclose a proposed or existing TIF Commitment at the Concept Meeting;
2. Determine the amount and terms of the TIF and whether or not the specific work in the TIF Commitment is included in the improvements for FHA-insured mortgage; and
3. Document that none of the TIF proceeds are used to support FHA-insured mortgage proceeds, or provide complete analysis and documentation demonstrating that the TIF funds and any tax benefits are irrevocably committed.

**T. Commercial Space.** Commercial facilities may be included in a mixed use project, subject to programmatic space and income limitations. See Chapter 7, Chapter 14.14, and Appendix 3A for further guidance.

**U. Military Impacted Areas.** HUD generally will not insure mortgages in designated military impacted areas unless HUD determines that demand from nonmilitary households is sufficient to sustain occupancy in both the insured project and the market as a whole. Section 238(c) of the National Housing Act authorizes the provision of insurance in military impacted areas upon certain findings by the Department of Defense (DOD) and HUD HQ. In such areas, borrowers should be encouraged to contact DOD for other potential programs administered by DOD which could provide alternative sources of financing for the proposed project. Section 238(c) loans are not eligible for MAP but may be processed under TAP.

**V. Student Housing.** Insured projects cannot be designed solely for student occupancy, although students and families are eligible occupants of insured family housing projects. Insured loans on projects in college areas must be underwritten at rents that are comparable to family housing in the area. Loans cannot be underwritten with rental rates assuming multiple student occupants in a unit that would result in a processing rent higher than a typical family apartment.

**W. Real Estate Requirements.** The insured mortgage must be on real estate:

1. Held in fee simple, or
2. Under a lease with a term of at least (i) ninety-nine years which is renewable, (ii) 50 years from the date the mortgage is executed, or (iii) for a period of not less than 10 years more than the loan maturity date, dependent upon the SOA.

**X. Transient Housing/Hotel Services Prohibition.** Section 513 of the National Housing Act prohibits the use of the insurance programs for transient or hotel purposes. Leases for less than 30 days are

prohibited and occupants cannot be provided with hotel services such as maid service, furnishing and laundering of linens, room service and bellboys. This also applies to any commercial space funded by the mortgage.

- Y. **Operating Deficit.** An operating deficit escrow is required on all applications for new construction and substantial rehabilitation to provide funding for operating expenses and debt service when net income is not available during the initial lease up and stabilization period. A debt service escrow may also be required on Section 223(f) proposals where analysis requires it. This escrow is not mortgageable and unused portions will be returned to the borrower. See Chapters 7.14 and 8.14 for more detail.
- Z. **Short-Term Lease Premiums.** Projects offering leases with terms of less than 30 days are not eligible for HUD-insured financing under any circumstances. Treatment of income from other short-term leases, e.g., furnished units, corporate or business short-term leases, may be considered to the extent that it is present in the local market for periods greater than 30 days. The actual number of furnished or corporate/business units generally may not exceed 10% of the units and must be approved by Asset Management at the time of underwriting. See Chapter 7 (Section 7.7.M) for short-term lease underwriting and valuation instructions, and other requirements.
- AA. **Replacement Reserve.** An Initial Deposit to the Replacement Reserve is funded at closing and monthly deposits are subsequently made from project operating income to pay for the eventual replacement of short-lived or capitalized physical assets. See Section 7.8 for the minimum annual replacement reserve requirements for all program types and Appendix 5G for guidance on completing a Capital Needs Assessment (CNA) for all insured projects every 10 years. Handbook 4350.4, Chapter 2 Servicing Manual, details the lender's responsibility for managing funds held for the project and describes the liquidity, draws and investment requirements.
- BB. **Developer Fees.** In Cost Controlled mortgages for FHA New Construction and Substantial Rehabilitation Programs (other than Section 231 Substantial Rehabilitation and Section 241(a)), Builder Sponsor Profit and Risk Allowance (BSPRA, or SPRA) is allowed. BSPRA is a mortgageable cost but not a source of cash. For affordable programs (such as Low Income Housing Tax Credits, RAD, and Section 202 refinancings), a Developer Fee may be mortgageable as long as BSPRA or SPRA is not also included. A summary of Developer Fee calculations limits for various FHA and assisted programs is included in Appendix 3B.
- CC. **Scattered Sites.** FHA insured multifamily properties may be traditional multifamily structures on one site, or may be detached, semi-detached, or row houses. Each property must consist of five or more dwelling units. Group homes are not eligible.

The site may consist of two or more noncontiguous parcels of land when the parcels comprise one marketable, manageable real estate entity and each parcel (or combination of contiguous parcels) has at least 5 units. (The regulations, 24 CFR 200.73(c), prohibit sites with less than 5 units.)

The following factors should be considered in underwriting, and determining whether a scattered site property is one marketable, manageable real estate entity:

1. Distance. Generally a greater distance would be acceptable in a rural area than an urban one, but we should never be seeing two projects funded by one FHA insured multifamily mortgage greater than 15 or 20 miles away from each other.
2. Physical condition, construction type, and age. If individual sites vary in these criteria, it is more difficult to make the case they comprise a single entity, and to evaluate the collateral (e.g. requiring separate CNA and Appraisal analyses, which are then combined. If they can't analyze it with one CNA and one Appraisal, it is not one real estate entity.
3. Occupancy type and turnover history.
4. Unit configuration and project layouts.
5. Expense volatility, particularly for single family structures or more widely disbursed properties. Risk in such cases must be mitigated by high-end expense estimates, and in some cases shorter amortization periods.

**DD. Condominiums.** A project built and platted as condominiums, but now operating as a rental project, may be refinanced under Section 223(f) if the condominium regime is held by a single owner with no individual unit ownership and the property meets other program guidelines, including the minimum occupancy standards. Condominium regimes are similarly permitted under new construction and substantial rehabilitation proposals that meet these same requirements.

Condominium ownership regimes may be recorded if the property is otherwise operated as a rental project with a single ownership entity owning all the apartments. Separate condominium units may be established for commercial use and for housing use which must include all the residential apartments. The insured loan must be secured by a mortgage on the rental apartments and mortgageable commercial space. Joint use and maintenance agreements and easements between the insured portion and any separately demised condominium portion must be defined, and all condominium fees must be equitably allocated.

The Regional Center or Satellite Office Director may consider a waiver for a condominium building with a limited number of individually owned units (i.e., 10% or less of total units) if all such units are located in a separate building or in a separate section of a single building apart from the rental units. HUD will not consider a waiver if any ownership units are interspersed with the rental units.

EE. **Environmental Review.** HUD has responsibilities to comply with various environmental laws and regulations. Lenders’ submission requirements assist in this review, as detailed in Chapter 9, Environmental Review.

FF. **Underwritten Occupancy.** Underwritten vacancy and collection loss rates will be the lesser of the minimum levels shown below and actual levels. The MAP Lender’s third party Appraiser should use actual vacancy rates, generally expected to be no lower than the rates below. The minimum vacancy rates allowed for underwriting and sizing mortgages determined with debt service calculations are as follows:

<i>Minimum Vacancy and Collection Loss Rate</i>	<i>Property Type</i>
3%	<ul style="list-style-type: none"> <li>• Properties with HAP contracts covering 90% or more of the units; <u>or</u></li> <li>• In-place rehab with:               <ul style="list-style-type: none"> <li>○ Occupancy at or above 90%, and</li> <li>○ 90% or more of the units set aside as LIHTC units, and</li> <li>○ Attainable Tax Credit rents at least 10% below market (i.e. “a 10% discount to market”).</li> </ul> </li> </ul>
5%	<ul style="list-style-type: none"> <li>• Properties with 80% or more of the units set aside as LIHTC units, and</li> <li>• Attainable tax credit rents at a 10% discount to market.</li> </ul>
7%	<ul style="list-style-type: none"> <li>• LIHTC properties with any percentage of units set aside but without a 10% discount to market; or</li> <li>• Properties in which 20% or more of the units are Market Rate.</li> </ul>

GG. All certifications submitted by the Lender in support of MAP applications should contain the following language:

I hereby certify under penalty of perjury that all of the information I have provided on this form and in any accompanying documentation is true and accurate. I acknowledge that if I knowingly have made any false, fictitious, or fraudulent statement, representation, or certification on this form or on any accompanying documents, I may be subject to criminal, civil, and/or administrative sanctions, including fines, penalties, and/or imprisonment under applicable federal law, including but not limited to 12 U.S.C. § 1833a; 18 U.S.C. §§1001, 1006, 1010, 1012, and 1014; 12 U.S.C. §1708 and 1735f-14; and 31 U.S.C. §§3729 and 3802.”

HH. **Waivers.** There are various references in the MAP Guide to HUD's waiver authority. Regulatory Waivers must be approved at the Assistant Secretary level, and certain waivers are reserved to HUD Headquarters. Regional Center Directors retain waiver authority for other provisions of the MAP Guide. While HUD may consider waiver requests within delegated authority, they will not be approved except for good cause, and Lenders should not assume approval.

### **3.2 New Construction/Substantial Rehabilitation Program Requirements**

Sections 220, 221(d)(4), 231 and 241(a) of the National Housing Act provide FHA multifamily mortgage insurance for the new construction or substantial rehabilitation of multifamily rental apartment properties. Section 213 is available for the new construction or substantial rehabilitation of Cooperatives, however those transactions will be processed under Traditional Application Processing (TAP).

The following requirements apply to *all* FHA New Construction/Substantial Rehabilitation multifamily mortgage insurance programs:

- A. Properties must have 5 or more residential units with complete kitchens and baths. (Section 231 requires at least 8 units.) Group Homes are not eligible for FHA multifamily mortgage insurance. SRO properties will only be considered if they have existing Project based Section 8 contracts in place.
- B. HUD can insure both the construction and permanent loan periods (Insurance of Advances) or just the permanent loan period (Insurance Upon Completion). Davis-Bacon wage requirements apply to new construction and substantial rehabilitation transactions for both Insurance of Advances and Insurance Upon Completion.
- C. New Construction transactions finance improvements where no construction work has been done to the site prior to Initial Endorsement. See Chapter 5 for additional information and exceptions.
- D. Substantial Rehabilitation transactions finance repairs and rehabilitation of existing properties that are or have been previously occupied. Projects in which construction of above ground improvements was started but not completed or inhabited are not eligible. The definition of substantial rehabilitation is based on either a per unit threshold for the cost of rehabilitation, or substantial replacement of two major systems. See Chapter 5.
- E. **Cost Certification.** The borrower must submit a cost certification prepared by an independent CPA upon completion of construction or substantial rehabilitation. The mortgage amount that is finally endorsed for insurance after completion of construction can be reduced based upon HUD review of the cost certified

amounts. General contractors or subcontractors are required to submit a cost certification if there is an identity of interest with the borrower. See Chapter 14 for Tax Credit project cost certification procedures and exemptions.

- F. **Federal Labor Standards.** The general contractor and all subcontractors for FHA-insured new construction or substantial rehabilitation transactions are required to comply with federal wage and reporting requirements under the Davis-Bacon Wage Act. Davis-Bacon requires the payment of prevailing wage rates and the submission of weekly certified payroll reports. Prevailing wage schedules may be obtained from the Regional Center or Satellite Office. There are limited exceptions to this requirement. Davis-Bacon Wage requirements do not apply for Section 241(a) in which the underlying first mortgage is a Section 223(f) loan that was not subject to Davis-Bacon requirements (or a Section 223(a)(7) loan) or for Section 241(a) loans for projects with a Secretary-held mortgage if the project did not originally have an FHA-insured loan that was subject to Davis-Bacon.
- G. **Assurance of Completion.** The general contractor shall provide an assurance of completion of construction on forms approved by HUD. See Section 8.14 for the specific requirements.
- H. **Absorption Period.** The absorption period used in estimating market demand for proposed newly constructed or substantially rehabilitated units is 18 months. Larger projects may phase in additional units under a separate application for mortgage insurance. An exception to the 18 month limitation on the absorption period may be considered by the Regional Center or Satellite Office Director for large high rise buildings which will be evaluated based on their own merit and will require a larger initial operating deposit.
- I. **Marketing, Leasing and (if applicable) Relocation Plan.** All projects that require absorption of units at economic rents to achieve break-even occupancy must submit a detailed marketing and leasing plan, and a budget reviewed and confirmed by the proposed property management company. The plan must discuss when marketing efforts will begin, when the leasing office and model units will open, how the leasing office will be staffed, and the project's marketing and advertising strategy. The plan must address timing of the construction progress schedule with respect to egress and ingress into the project, landscaping and access to amenities. These items are in addition to those required by the Affirmative Fair Housing Marketing Plan. For substantial rehabilitation projects involving temporary relocation or displacement of residents, the marketing, leasing and relocation plan must address details of timing, funding and management of the relocation process.

The relocation plan must be consistent with the applicable HUD program related regulations concerning displacement, relocation and acquisition, in addition to the requirements of the Uniform Relocation Assistance and Real Property Policies Act of 1970 (URA) and Section 104(d) of the Housing and Community Development Act of 1974 (section 104(d)) to the extent those laws and implementing regulations are applicable to the undertaking.

The URA may apply to an undertaking if a property will be receiving Project Based Section 8 assistance or other federal financial assistance in connection with related acquisition, rehabilitation

(repairs) or demolition activities. Section 104(d) may apply when a lower-income dwelling is demolished or converted to a use other than lower-income housing in connection with a Community Development Block Grant Program (CDBG) or HOME Investment Partnership Program (HOME) funded activity. See Appendix 3E for additional information about these requirements.

In addition to any applicable requirements associated with permanent tenant displacement, the URA and applicable HUD program regulatory requirements may also require compliance for temporary relocation of tenants caused by the project. Generally, when there is temporary relocation in covered projects, persons must be reimbursed for all reasonable increased out of pocket expenses in connection with their temporary relocation including but not limited to moving expenses and increased housing costs. Project owners should consult, and the Lenders application should ensure compliance with, any and all applicable temporary relocation requirements. See Appendix 3E for additional information about these requirements.

Federal insurance, including FHA mortgage insurance, is excluded from the definition of Federal financial assistance under the URA and, therefore, does not trigger URA requirements on its own. Underwriters must however evaluate and mitigate the risk of impact of relocation, and to the extent reasonably possible, FHA mortgage insurance applications should minimize any negative impact during or after the rehabilitation period on existing residents. Generally, a relocation plan should include the following elements:

- Accurate data, dates and dollars.
- Who is responsible – the individuals, their names, contact information and roles provided? Requires a designated Relocation Liaison with right skill set – not the Property Manager, not the Contractor. Liaison needs to attend site meetings.
- Which residents are moving in which specific units?
- When. A relocation schedule with specific dates for each unit, sequenced and coordinated with the construction schedule.
- How will effective communication be done, how and who is responsible for packing, moving, inspections (in and out), dealing with residents' special needs or complaints, etc.
- An accurate cost of relocation so that the relocation escrow is correct.

**J. Working Capital Escrow.** The Working Capital Escrow is designed to cover accruals of taxes, insurance, and interest above the amounts capitalized in the mortgage in the case of construction delay. The escrow may also be used to pay for construction contingencies for cost overruns and change orders, and other miscellaneous expenses which are not included in the mortgage, and required for new construction and substantial rehabilitation proposals. See Section 8.13 for general requirements and Section 12.15.C for working capital escrow release instructions.

**K. Furniture, Fixture and Equipment (FF&E) in Cost Basis.** Reasonable costs of Furniture, Fixture and Equipment may be included in mortgageable project costs and in the Reserves for Replacement

for new construction and substantial rehabilitation proposals. See Chapter 5, Section 5.11.D.4.i for FF&E examples and guidance. All funded FF&E will be subject to HUD's security instruments.

- L. **Elderly Developments.** New construction or substantial rehabilitation of apartments specifically designed with occupancy restricted to the elderly age 62 and over should be processed under Section 231. Age restricted projects are not eligible under Section 220. Age restricted Multifamily projects may be considered under other Sections of the Act (e.g., Section 221(d)(4) or 223(f)) so long as they comply with the provisions of Section 3.1.O.
- M. **Occupancy Preference.** Sponsoring nonprofit organizations such as labor unions, professional groups, religious organizations, and fraternal or civic organizations, may give preference to their members, provided membership in the organization is open without regard to race, color, national origin, sex, sexual orientation, gender identity, marital status, age, disability or religion. However, sponsors cannot restrict occupancy solely to their members. Preferences may also be given to other groups such as veterans, homeless persons, victims of domestic violence, etc.

Residency preferences may only be used under conditions specified in the Affirmative Fair Housing Marketing Plan instructions and 24 CFR 5.655( c)(1), so that they may not create a disparate impact in selection against protected classes. In no case may special preference be given to children of current residents since the demographics of housing markets and labor pools change. Similarly, projects (regardless of ownership) may target occupancy to various demographic groups (such as "workforce housing") so long as there is sufficient and sustainable market and Affirmative Fair Housing Marketing Plans and other management plan exhibits demonstrate the property will not discriminate against any particular race, color, nationality/ethnicity, religion, sex, disability, familial status (children of all ages and pregnant women), sexual orientation and gender identity and age.

- N. **Builder and Sponsor's Profit and Risk Allowance (BSPRA) and Sponsor's Profit and Risk Allowance (SPRA)** are allowed (but not required) for new construction and substantial rehabilitation applications under Sections 221(d)(4), 220, and 231 for profit motivated and limited distribution borrowers. Non-profit borrowers are eligible for a developer's fee, or they may apply as a for-profit entity for purposes of applying for FHA mortgage insurance, as provided in Chapter 8.

1. The BSPRA allowance will be credited against the borrower's required equity contribution. To use BSPRA, there must be an identity of interest between the borrower and general contractor and there must be no paid builder's profit contained in the mortgage calculation. For new construction, BSPRA is 10% of the estimated cost of: on site improvements, structures, general requirements, general overhead, architect's fees, carrying charges and financing, legal, organizational and audit expenses (total of lines 50, 63 and 67 in Section G. of Form HUD-92264), exclusive of land. For substantial rehabilitation projects, BSPRA is 10% of the above costs exclusive of the as is value of the existing structure.

2. SPRA may be included in replacement cost where no identity of interest exists between the general contractor and borrower, or where there is an Identity of Interest but the borrower and general contractor have agreed a general contractor profit instead of BSPRA. SPRA is 10% of the total estimated cost of: architect's fees, carrying and financing charges, legal, organizational, and audit expenses.

O. **Energy Efficiency.** New construction projects must comply with the International Energy Conservation Code (IECC) 2009 for buildings up to three stories, or in the case of buildings over three stories, American Society of Heating, Refrigeration and Air-conditioning Engineers, ASHRAE Standard 90.1 2007 edition (or such later versions as may be adopted by the Secretary of HUD), pursuant to the requirements of the Energy Independence and Security Act of 2007(Public Law 110-140). “Gut” rehabilitation projects must conform to these energy codes except where compliance cannot be obtained due to required preservation of historic buildings or elements of historic buildings. When a CNA for existing buildings includes an energy audit meeting the requirements of ASHRAE level II, and when the CNA describes potential future savings if recommended energy efficiency measures are adopted, up to 75% of projected energy savings may be recognized.

P. **Cost vs. Value.** Most FHA multifamily new construction and substantial rehabilitation programs are based on cost rather than value when sizing the mortgages (in Criterion 3 of Form HUD-92264A). Exceptions are Sections 231 and 241(a) programs, which have value limitations. For substantial rehabilitation under all Sections of the Act, the “as is” value of the project is a component of the cost. “As is” value of a substantial rehabilitation project will be the lesser of the value “as is”, reflecting actual occupancy and any restrictions on NOI, or the purchase price at closing if it is an arms-length acquisition transaction.

### **3.3 Section 221(d)(4) Mortgage Insurance for Rental and Cooperative Housing - New Construction and Substantial Rehabilitation**

Section 221(d)(4) insures mortgages for the new construction or substantial rehabilitation of rental housing. In addition to the general requirements in Sections 3.1 and 3.2, the requirements in this section apply to the Section 221(d)(4) program:

Maximum Loan Ratios and Debt Service Coverage Ratios. The following loan ratios and percentages control the loan amount and are the mortgage criteria detailed on the Form HUD-92264-A, Supplement to Project Analysis. The lowest of the mortgage criterion controls the loan amount.

Section 221(d)(4)

New Construction and Substantial Rehabilitation

Criterion 1:

Loan Amount Requested in the Application. The requested application amount may be amended when appropriate, e.g. when a higher mortgage is supportable due to a drop in rates.

Criterion 3:

Amount Based on Replacement Cost: The applicable percentage of the estimated replacement cost for new construction or the applicable percentage of the sum of the estimated replacement cost for substantial rehabilitation plus the “as is” value of the property before substantial rehabilitation is:

- a. 90% - for projects with 90% or greater rental assistance;
- b. 87% - for projects that meet the definition of Affordable Housing; or
- c. 85% - for market rate projects

Criterion 4:

Amount Based on Limitations per Family Unit: Where percentages are required, enter the same percentage applied under Criterion 3. See Chapter 8 for complete details and the MF Housing website: <http://www.hud.gov/offices/hsg/mfh/hicost/hicost.cfm> on information for per family unit limitations and the High Cost Percentage by jurisdiction.

Criterion 5:

Amount Based on Debt Service Ratio (DCR) (ratios are rounded for presentation purposes):

- a. 90% (1.11 DCR) – for projects with 90% or greater rental assistance;
- b. 87% (1.15 DCR) – for projects that meet the definition of Affordable Housing; or
- c. 85% (1.176 DCR) - for market rate projects

### **3.4 Section 220 Mortgage Insurance for Rental Housing for Urban Renewal and Concentrated Development Areas – New Construction and Substantial Rehabilitation**

Section 220 insures mortgages for the new construction or substantial rehabilitation of mixed use housing projects in urban renewal areas, code enforcement areas and other areas where local governments have undertaken designated revitalization activities.

In addition to the general requirements in Sections 3.1 and 3.2, the following requirements apply to Section 220:

A. Eligible Areas. The property must be located in either a concentrated development area approved by the Multifamily Regional Center or Satellite Office, or one of the following:

1. Existing slum clearance and urban redevelopment projects covered by a Federal aid contract before the effective date of the Housing Act of 1954.
2. An approved urban renewal area under Title I of the Housing Act of 1949.
3. Disaster urban renewal projects assisted under Section III of the Housing Act of 1949 as amended.
4. An area of concentrated code enforcement being carried out under Section 117 of the Housing Act of 1949.

The Multifamily Regional Center or Satellite Office will consider proposals in concentrated development areas in which concentrated housing, physical development and public service activities are being carried out in a coordinated manner, pursuant to a locally developed strategy for neighborhood improvement, conservation or preservation. Locally developed strategies may be informal, but must:

- a. Provide for a combination of physical improvements, necessary public facilities and services, housing programs, private investment and citizen self-help activities appropriate to the needs of the area,
- b. Coordinate public and private development efforts, and
- c. Provide sufficient resources to produce substantial long-term improvements in the area within a reasonable amount of time, taking into account the severity of the area's problems.

B. Commercial Facilities. Commercial space may be included if it will serve the needs of the project residents and other residents of the area. Commercial space is limited to 25% of total net rentable area and commercial income to 30% of effective gross project income.

See Section 7.7 and Section 7.8 for requirements where commercial facilities are included in a project.

C. Maximum Loan Ratios and DCRs. The controlling mortgage criteria for Section 220 loans are the same as for the Section 221(d)(4) program, detailed above.

D. Builder/Sponsor Profit and Risk Allowance (BSPRA). See definition of BSPRA in Section 3.2.N.

E. Sponsor Profit and Risk Allowance (SPRA). See definition of SPRA in Section 3.2.N.

F. Elderly Developments. Apartments specifically designed for the elderly, limited to elderly occupancy, and/or seeking to use the Fair Housing Act's housing for older persons exemption are not permitted under Section 220.

### **3.5 Section 231 Mortgage Insurance for Rental Housing for Elderly Persons – New Construction and Substantial Rehabilitation**

Section 231 insures mortgages for construction and substantial rehabilitation of rental housing for elderly persons (aged 62 or older) and/or persons with disabilities. A project must comprise 8 or more new or substantially rehabilitated units designed for occupancy by elderly persons and may include family units for occupancy for persons who qualify as handicapped.

#### **A. Definitions/Explanations of Terms:**

1. Elderly Person. A person aged 62 or older. For Section 231 occupancy, other than for units designed for the use and occupancy of handicapped persons and their families for up to 25% of the units, all persons living in a unit must be age 62 or over.
  2. Handicapped [“disabled”] Person. A person who has a physical impairment which:
    - (1) Is expected to be of a long-continued and indefinite duration;
    - (2) May substantially impede his/her ability to live independently; and
    - (3) Is of such a nature that his/her ability to live independently could be improved by more suitable housing conditions.
- B. Room Lay Out, Design and Special Amenities. Particular attention is to be given to room lay out and unit design to assure they are consistent with the needs of the elderly or handicapped market.
- C. BSPRA or SPRA allowances are eligible under Section 231 new construction transactions so long as there is no Developer Fee. These allowances are not available for Section 231 substantial rehabilitation transactions, which may be constrained by value. See Section 3.42.N. for an explanation of these allowances.
- D. Maximum Loan Ratios and DCRs. The controlling mortgage criteria for Section 231 loans are the same as for the Section 221(d)(4) program, detailed above, with the exception of criterion 3 for substantial rehabilitation loans, which is controlled by the applicable percentage of “as rehabilitated” value (not cost).

### **3.6 Section 241(a) Mortgage Insurance for Supplemental Loans for Multifamily Projects**

- A. Eligibility. Section 241(a) is now a MAP-eligible program. It provides secondary financing for improvements or additions to properties with a HUD-insured first mortgage which need repairs, substantial rehabilitation, or additional units.
1. Projects with HUD held debt (as opposed to FHA-insured), or Risk Share financing are not eligible to apply for Section 241(a) loans.
  2. Improvements, such as fire safety improvements, energy conservation measures, updated security systems, or substantial rehabilitation may be financed with a Supplemental Loan. As a general rule, repairs to an existing project that are not extensive enough to be classified as substantial rehabilitation should be paid for by funds other than a Supplemental Loan. However, if there are major repairs required and other funds are not available in the replacement reserve, the sponsor may seek a Supplemental Loan under Section 241(a).
  3. Construction of additional units, or expansion of the foot print of the existing building, is allowed. Such work may be completed on the existing parcel secured by the first mortgage, or a contiguous or nearby parcel acquired and included in an amendment to the existing first mortgage security documents.
  4. A cross-default provision should be placed in the Section 241(a) mortgage loan documents such that a default under a “prior recorded insured mortgage” will trigger a default under the Section 241(a) mortgage. Conversely, a default under the Section 241(a) loan should not trigger a default under the first mortgage.
- B. Term. The Section 241(a) loan should generally be coterminous with the underlying FHA-insured first mortgage if that loan has more than 25 years remaining on its term. If less than 25 years remain on the term of the first mortgage, HUD will consider an amortization period up to 40 years regardless of the underlying first mortgage’s amortization period so long as the term is no greater than 75% of the project’s remaining useful life.
- C. Equity requirement and controlling mortgage criteria. The owner is required to contribute at least 10% of the total development cost of the transaction. Existing reserve for replacement deposits in excess of the Initial Deposit requirement concluded in the CNA and underwriting may be used to meet the equity requirement. Similarly, land equity from adjacent or nearby parcels added and incorporated into the existing first mortgage security and additional cash contributions can be used to meet the 10% equity contribution requirement. Residual Receipt account funds (e.g., from surplus Section 8 funding) cannot be used to meet equity requirements. Imputed equity representing the difference between the “as is” value of the project and the existing indebtedness is not available to meet the equity requirements. The HUD Form 92264 and 92264A should recognize only the cost of the addition or improvements but, should include all (i.e. the existing and proposed) project Net Operating Income

(NOI) in Criterion 5 of Form HUD 92264A. A supplemental analysis comparing the historical and proposed NOI should be included as an attachment to the HUD-92264.

Criterion 3: Loan to Value / Cost.

A Section 241(a) supplemental loan is limited by statute to 90% of the HUD-estimated value of the improvements, additions or equipment, regardless of the Section of the Act insuring the underlying first mortgage. The cost of the repairs and transaction costs (including the acquisition price of an adjacent or nearby land parcel) will be recognized as the value, so long as any additional land purchased or contributed is no more than the fair market value. Regardless of the Section of the Act of the underlying first mortgage, neither BSPRA nor SPRA may be recognized. The cost of the transaction can and should include builder's profit (regardless of whether there is an Identity of interest.)

Criterion 4: Statutory Limits.

The Supplemental Loan, when added to the outstanding balance of the mortgage covering the project or facility, may not exceed the maximum statutory limitation applicable to the building and unit type for the Section of the Act under which the existing first mortgage is insured.

Criterion 5: Debt Service Coverage Ratio.

The maximum loan amount under this criterion is debt service (in combination with the first mortgage payments) supported by 90% of projected NOI.

- D. CNA, Plans and Specifications, and Cost Estimate requirements. A complete CNA, including reserve for replacement analysis, is required for all Section 241(a) loans. The repair list should be supplemented with Plans, Specifications, and Cost analysis per requirements for Section 221(d)(4) or other new construction or substantial rehabilitation loan programs.
- E. Davis-Bacon Act applicability. Davis-Bacon Wage requirements apply for all Section 241(a) loans except (i) those in which the underlying first mortgage is a Section 223(f) loan that was not subject to Davis-Bacon requirements (or a Section 223(a)(7) loan), and (ii) those for projects with a Secretary-held mortgage if the project did not originally have an FHA-insured loan that was subject to Davis-Bacon.
- F. Insurance of Advances or Insurance upon Completion. Either approach is acceptable. Construction advances for any Supplemental Loan may be insured; the minimum amount of advance that may be insured is \$200,000. Mortgageable contingency and construction draw retainage are subject to the same requirements as other New Construction / Substantial Rehabilitation programs.
- G. Environmental Assessments. An environmental assessment per Chapter 9 is required for Section 241(a) loans used to fund significant improvements, additional units or an increase in a building footprint.

H. Working Capital and Operating Deficit Reserves. The working capital and operating deficit reserves requirements are the same as those of the Section 221(d)(4) program. The lender can recommend, and HUD may approve, waiving the requirements when appropriate on specific cases. A default under the first mortgage will constitute a default under the Section 241(a) loan.

### **3.7 Section 207/223(f) Mortgage Insurance for Purchase or Refinancing of Existing Multifamily Rental Housing**

Section 207/223(f) insures mortgages for the purchase or refinancing of existing rental housing which may have been financed originally with conventional mortgages or equity. The use of Section 223(f) for Cooperative Multifamily Housing is described in Chapter 17. Properties requiring substantial rehabilitation are not eligible for this program. HUD requires completion of critical repairs before endorsement of the mortgage and permits the completion of non-critical repairs after endorsement.

A. Eligible Properties. The property must contain at least 5 residential units. Properties must have been completed or substantially rehabilitated at least 3 years before the date of application.

Properties that were constructed or substantially rehabilitated with HUD-insured multifamily mortgages, and the latent defects guarantee period has expired, are exempt from the 3-year rule. Projects with additions completed less than 3 years before the application are eligible for refinancing as long as the size and number of units in the addition are not larger than the size and number of units in the original project.

B. Ineligible properties.

1. Manufactured home parks, Section 202 or 811 projects funded after 1990 by Capital Advances and/or Project Rental Assistance Contracts (PRACs) and group homes are not eligible under this Section.
2. Properties whose required repairs are so extensive that they meet the threshold for substantial rehabilitation are not eligible under this Section.
3. Properties with meal services or other features typical of or unique to Retirement Service Centers. Although, there is a potential exception to allow otherwise prohibited services for refinancing Section 202 properties or HUD-insured properties with Project-Based rental assistance so long as they are offered on an optional basis, projects with mandatory meal service are not eligible.

C. In addition to the general requirements in Section 3.1, the following requirements apply to Section 223(f) when used for acquisition or refinancing:

- 1) Any property acquired by the borrower before the date of the mortgage insurance application shall be treated as a refinance transaction;
- 2) Any property acquired the borrower after the date of the mortgage insurance application shall be treated as a purchase; and
- 3) In a purchase transaction, any identity of interest, however minor an interest, between seller and purchaser requires the application to be processed as a refinance. (Acquisitions to facilitate Low Income Housing Tax Credit transactions are an exception to this requirement.)

D. Repairs.

1. Critical repairs must be performed prior to endorsement.
2. Non-critical repairs, approved by HUD, may be completed after endorsement with work write-ups sufficiently detailed to facilitate inspections, schedules for completion of repairs, complete bids on work items greater than \$25,000, and a financial escrow equal to 120% of the non-critical repair costs that must be established at closing. The 20% escrow above the 100% of the non-critical repair cost is non-mortgageable and may be reduced to 10% for affordable transactions.

E. Fair Housing Act Noncompliance. Any property available for first occupancy after March 13, 1991, that is in noncompliance with Fair Housing Act design and construction requirements, must, as a condition of insurance, be modified/retrofitted to comply with Fair Housing Act accessibility guidelines. HUD may approve the modifications/retrofits to be completed after endorsement with appropriate financial escrows at closing, and the work must be performed in accordance with instructions in Section 5B "Accessibility for Persons with Disabilities."

F. Elderly or Age Restricted developments. Projects with existing elderly occupancy or age restrictions are eligible for refinancing under Section 223(f) as long as the property meets the requirements of Section 3.1.O and does not contain the features of the Section 232 program.

G. Prior Defaults/Claims or Departmental Enforcement Center Referrals. HUD does not prohibit applications for mortgage insurance for formerly HUD-held loans but will not accept any application from a borrower/principal who has had a previous loan or other financial relationship with HUD and not proven to be a good business partner, or for a property which has proven to be unsuccessful in the past. The lender should accept such applications only after they have documented the economic, physical, operational or management changes that have occurred which would justify an application for new insurance. A concept meeting prior to submission is required to address the past experience of the loan and of the borrower/principal including past Regulatory Agreement compliance. Similarly, the lender should ensure that the borrower, the proposed management agent, and/or the Project have not been referred to HUD's Departmental Enforcement Center (DEC), or if such a referral has been made, that all issues have been or will be resolved.

- H. Labor standards. Davis-Bacon prevailing wage requirements do not apply to Section 207/223(f).
- I. Prepayment Provisions and Prohibition. The National Housing Act prohibits prepayment of loans insured under Section 223(f) for 5 years from the date of endorsement for insurance except where at the time of prepayment:
1. The borrower enters into an agreement with HUD to maintain the property as rental housing for the remainder of the specified 5 year term;
  2. HUD determines that the conversion of the property to a cooperative or condominium ownership is sponsored by a bona fide resident organization representing the majority of households in the project;
  3. HUD determines that continuation of the property as rental housing is unnecessary to assure adequate rental housing for low and moderate income residents of the community; or
  4. HUD determines that continuation of the property as rental housing would have an undesirable and deleterious effect on the community.

The statutorily imposed prepayment restriction is not intended to prohibit refinancing under Section 223(a)(7) though the terms of a Ginnie Mae or other mortgage backed security or bond financing may restrict prepayment. A Section 223(f) Use Agreement is required for a refinancing of an existing Section 207 insured loan pursuant to Section 223(f)/ 223(a)(7) if the mortgage is aged less than five years from the Final Endorsement date.

- J. Eligible Borrowers. Both for-profit and nonprofit Single Asset Mortgagor Entities are eligible to apply. Tenants-in-common, Delaware Statutory Trusts, and natural persons are not eligible single asset mortgagor entities but, can hold “upper-tier” ownership interests.
- K. Maximum Loan Ratios and Debt Service Coverage Ratios. The following loan ratios and percentages control the loan amount and are detailed on the Form HUD-92264-A, Supplement to Project Analysis, mortgage criteria. The lowest of the mortgage criterion controls the loan amount.

Section 223(f)  
Refinance and Acquisition Processing

Criterion 1:

Loan Amount Requested on Application. The requested application amount may be amended when appropriate.

Criterion 3:

Amount Based on Value: The applicable percentage of the estimated value of the property after completion of repairs and improvements.

- a. 90% - for Section 202 & 202/8 direct loans and for projects with 90% or greater rental assistance
- b. 87% - for projects that meet the definition of Affordable Housing and for which the achievable Tax Credit rents are at least 10% below market rents; or
- c. 85% - for market rate projects or Tax Credit projects without a significant rent advantage (i.e. the achievable rents are at least 10% below market.)

Criterion 4:

Amount Based on Limitations per Family Unit: Where percentages are required, enter the same percentage applied under Criterion 3. See Chapter 8 for complete details and the MF Housing website: <http://www.hud.gov/offices/hsg/mfh/hicost/hicost.cfm> on information for per family unit limitations and the High Cost Percentage by jurisdiction.

Criterion 5:

Amount Based on DCR (ratios are rounded for presentation purposes):

- a. 90% of NOI (1.11 DCR) - for Section 202 & 202/8 direct loans and for projects with 90% or greater rental assistance
- b. 87% of NOI (1.15 DCR) - for projects that meet the definition of Affordable Housing and for which the achievable Tax Credit rents are at least 10% below market rents; or
- c. 85% of NOI (1.176 DCR) - for market rate projects or Tax Credit projects without a significant rent advantage (i.e. the achievable rents are at least 10% below market.)

Criterion 7: Acquisition Applications

Amount Based on Total Cost of Acquisition Section 223(f). The following percentages apply to Line 7d. (i.e. formula to compute the loan closing charges) and Line 7h.:

- a. 90% - for Section 202 & 202/8 direct loans and for projects with 90% or greater rental assistance
- b. 87% - for projects that meet the definition of Affordable Housing and for which the achievable Tax Credit rents are at least 10% below market rents; or

- c. 85% - for market rate projects or Tax Credit projects without a significant rent advantage (i.e. the achievable rents are at least 10% below market.)

Criterion 10:

- L. The greater of 80% of LTV, or the Cost to Refinance. Cash Out/Equity Out Proceeds. Fifty percent (50%) of any cash out proceeds after funding mortgageable transaction costs and the assurance of completion requirements must be held in an escrow by the lender until the required non-critical repairs are completed and HUD approves the release. (See Chapter 8 for detailed escrow release instructions, and waiver conditions).
- M. Reserve for Replacements. An Initial Deposit and Annual Deposits must be made to the Reserve for Replacements in accordance with the CNA and underwriting conclusions.
- N. Secondary Financing. HUD permits secured secondary financing on Section 223(f) loans up to total debt of 92.5 Loan-to-Value, or as otherwise specified for affordable housing projects. (See Chapter 8 and chapter 14 for details.)
- O. Commercial Space. Commercial space is limited to 25% of total net rentable area and commercial income to 20% of effective gross project income.
- P. Real Estate Requirements. The mortgage must be on real estate held:
  - 1. In fee simple; or
  - 2. Under a leasehold estate approved by HUD for not less than ninety-nine years which is renewable or with a minimum term of 50 years from the date the mortgage is executed. Both the land and the improvements may be subject to the leasehold, so long as OGC determines there is adequate security for the loan.
- Q. Mortgage Term. The maximum term of the mortgage is 35 years or 75% of the remaining economic life of the property, whichever is less, provided that the term may not be less than 10 years.
- R. Firm Commitment Processing Only. Lenders should participate in a concept meeting with the Regional Center or Satellite Office prior to application submission if there are concerns about marketability, environment, competing proposals or for particularly complex financing structures or projects with significant cash out or large loans.
- S. Physical Occupancy Standards. Section 223(f) has minimum and maximum physical occupancy underwriting requirements. See Section 7.7.G for further details.

T. Market Study. Section 223(f) applications typically do not require a market study separate from that contained in the appraisal. However, in volatile or declining markets, the lender should consider and may be required to obtain a market study to support the underwriting conclusions of market demand for the property over the loan term. Regional Center or Satellite Office staff should consult with Economic Market Analysis Division (EMAD) in such cases. Requirements for market studies are contained in Chapter 7.

U. Discounts and/or Costs of Issuance associated with bond financing may be eligible for inclusion in the computation of Criteria 7 and 10.

1. Review documentation regarding permanent financing. Documentation must state the amount of the discounts, financing fees, and/or costs of issuance to be charged and with whom they will be paid.
2. Permanent Placement Fee. This fee must include all permanent placement expenses, including lender's legal fees, except discounts. Where Ginnie Mae Mortgage-Backed Securities (MBS) are involved and the mortgagee charges:
  - a. The maximum permanent placement fee, it may not assess an additional charge for either the MBS application fee and/or the securities custodial fee.
  - b. Less than the maximum permanent placement fee, it may assess an additional charge for either the MBS application fee and/or the securities custodial fee provided the total fees and charges do not exceed the dollar value of the maximum permitted permanent placement fee.
3. Determine if the discounts, financing fees and costs of issuance are reasonable and generally in line with prevailing market conditions and mortgage credit data.  
Recognize financing fees and discounts charged by the permanent lender, for inclusion in the mortgage:
  - a. Bond fees included in the mortgage transaction:
    - (1) Where a project is to be financed through the sale of either taxable or tax-exempt bonds, the maximum financing fees allowable in the mortgage computation and recognizable for cost certification purposes is 5.5% of the mortgage amount. Any cost beyond the 5.5% must be paid from sources outside the mortgage.
    - (2) The maximum financing fee the mortgagee may retain for its own account is 3.5% to cover the costs of origination, permanent placement, processing, underwriting, closing and delivery (including the mortgagee's legal fees), escrow monitoring, etc. The remaining 2% (or such greater percentage as may result from the lender reducing its maximum retained 3.5% fee) may be used to offset the bond fees.

b. Discounts. In a refinancing or purchase transaction, discount fees will be recognized only for those actual costs charged by the placement lender, which are determined to be eligible. Discounts included in the computation of Criteria 7 and 10 must be reasonable based on current market conditions.

V. Defeasance costs associated with underlying bond financing, yield maintenance, swap termination fees, or costs to satisfy similar derivative instruments will only be recognized in the eligible cost basis up to 10% of the requested FHA loan amount. Defeasance costs greater than 10% of the proposed FHA insured loan amount may only be paid from equity-out when the loan amount is less than or equal to 80% LTV.

### **3.8 Section 223(a)(7) Refinancing of Existing Insured Mortgages**

The Section 223(a)(7) program is more fully described in Chapter 18 of this Guide. The program was included as a MAP Program in July 2010, and provides for streamlined refinancing of currently insured FHA loans. Accordingly, some requirements of MAP processing for other multifamily programs are not required. The following is a summary of the program features:

Eligibility: Only currently FHA insured loans are eligible. HUD held loans are not eligible unless subject to a Mark-to-Market Debt Restructuring under MAHRAA. Risk Share loans are not eligible (by statute). Properties which need substantial repairs or propose new construction (e.g. of additional units or other permanent structures) are not eligible.

Terms: Most transactions are processed with a lower interest rate, and re-amortized either within the remaining term or with an extension up to 12 years. Exceptions are detailed in chapter 18. Extended amortizations may reduce risk to the Department by lowering debt service requirements so long as the CNA evidences the physical condition supports the extended term of the mortgage. In every case, the loan term cannot exceed 75% of the remaining useful life of the property.

Controlling Mortgage Criteria: The loan is limited to the lesser of the original principal balance, the existing indebtedness plus transaction costs, and that which can be supported by 90% of NOI (95% for projects with greater than 90% Project-Based Rental Assistance).

Lender Fees: Chapter 18 provides more detail. The one exception to the prohibition on inducements is the payment of pre-payment penalties on an existing FHA insured loan from lender's profit. The lender may pay such pre-payment penalties on behalf of the borrower, so long as disclosed to and approved in advance by HUD. Pre-payment penalties payable by lenders may include the cost of defeasance or penalties associate with bond financing, or defeasance of other mortgage-backed securities (including

Ginnie Mae securities), so long as the amount does not exceed 10% of the proposed FHA insured loan amount.

Borrower Fees: Lenders cannot pay application or due diligence fees on behalf of the borrower, or other payments as an inducement. To do so would be considered a kick-back, and a basis for Enforcement action. This broad prohibition applies to affiliates of either the lender or the borrower, and includes any payment or contribution from the lender directly to the borrower or in support of their interests. Other than to pay for CNA costs, existing Reserve for Replacement deposits (for HUD held or FHA insured mortgages) are not available for application fees or other transaction costs.

CNA: A complete CNA is required, including intrusive testing for older properties. The format, content, and scope of a required CNA will not be waived. Given properties applying for Section 223(a)(7) are already FHA insured, HUD will, in evaluating the CNA, exercise greater flexibility in sizing the reserves for replacement requirements and timing of repairs, so long as the physical and financial integrity of the project is ensured, and the owner and management agent are in good standing.

Assuming the project has acceptable REAC scores and HUD Asset Management staff concurs, HUD will consider waivers for projects which completed construction or a substantial rehabilitation, or had a CNA done within the last 5 years. In such, cases, a CNA will be required sooner than the normal schedule of every 10 years.

Other Issues: Projects in which the repairs or rehabilitation is extensive enough to require an Environmental Assessment or compliance with Davis-Bacon Wages, are not eligible for Section 223(a)(7) refinancing.

An officer of the lender who is an approved signator must sign the application. Site visits and an approved MAP underwriter are generally not required, though the physical condition or other issues in specific transactions may require such a site visit and underwriter review.

Prepayment approval must be requested by the servicing mortgagee at the time of the application. When the refinancing is being performed by a different firm than currently services the loan, a letter accompanying the Firm Commitment application and signed by the borrower to the Servicing lender notifying them of their intent to refinance and requesting their filing of the HUD form 9807 will be accepted in lieu of the actual request for prepayment approval.

## 3.9 Property Insurance Requirements

### A. Insurance During Construction.

1. Public Liability Insurance on a Commercial General Liability form with limits of not less than \$500,000 per occurrence to protect the mortgagor during the construction phase from claims involving bodily injury and/or death and damage to the property of others. Such Commercial General Liability Insurance must be endorsed to include owners' and contractors' protective coverage.
2. Vehicle Liability Insurance with limits of not less than \$300,000 for one person and \$500,000 for more than one person to protect the mortgagor for claims for bodily injury and/or death, and not less than \$100,000 against claims for damage to property of others arising from the owner's operation of vehicles. Such insurance must include coverage for employer's owned, non-owned and/or hired vehicles, where applicable.
3. For properties in a Special Flood Hazard Area on a FEMA Flood Insurance Rate Map, flood insurance is required during construction when the property becomes insurable, and upon completion, in the amount required by the Flood Disaster Protection Act of 1973.

### B. Permanent Insurance. Upon acceptance of the project, or any portion thereof from the contractor, the lender must provide a certified duplicate copy of the following insurance coverage. In some instances, continuation of the insurance obtained for the construction period, with proper endorsements thereto, will be acceptable. In any event, the lender must assure that there is no gap period in insurance protection during the transition from the Insurance During Construction to the Permanent Insurance.

1. Public Liability Insurance on a Commercial General Liability form with limits of not less than \$500,000 per occurrence to protect the mortgagee from claims involving bodily injury and/or death and property damage which may arise from the mortgagee's operations, including any use or occupancy of its facilities, grounds and structures, and must include independent contractors coverage, where applicable.
2. Vehicle Liability Insurance. If the mortgagee owns a vehicle in the operation of the project, including non-owned and/or hired vehicles operated for the benefit of the mortgagee, the mortgagee must maintain Vehicle Liability Insurance. Such insurance must provide for limits of liability of not less than \$300,000 for one person and \$500,000 for more than one person to protect the mortgagee from claims for bodily injury and/or death, and not less than \$100,000 against claims for damage to property of others.
3. For properties in a Special Flood Hazard Area on a FEMA Flood Insurance Rate Map, flood insurance is required during construction when the property becomes insurable, and upon completion, in the amount required by the Flood Disaster Protection Act of 1973.
4. Casualty Insurance.

Also known as "fire and extended coverage" is insurance to protect borrowers (and lenders and HUD) from losses caused by fire, storm, wind and similar accidents or natural hazards.

- i) **Insurable Values.** The amount of damages covered and the amount of coverage needed are both based on the replacement cost of individual buildings not including land or site improvements, meaning the actual current cost of replacing the building, not value or depreciated original cost. For each building this sum is known as its “insurable value.” The dollar amount payable in any casualty event will not exceed the actual cost of damages calculated on a building by building basis and for each building will not exceed the insurable value for that building. For this reason, methods of estimating insurable value that prorate gross cost among dissimilar buildings may under (or over) state actual replacement cost resulting in a risk of loss not covered by insurance. Most states regulate casualty insurance coverage and prohibit “over insurance” because it is an inducement to arson and insurance fraud. For HUD programs, replacement cost (insurable value) must be estimated for each structure in a property and is reported on form HUD 92329 (See Chapter 5 and Appendix 5G).
- ii) **Minimum Coverage Amount.** Provided that any co-insurance requirement is met (see below), the borrower must provide casualty insurance with a face amount which is the lower of: 80% of insurable values; or the balance of the insured mortgage(s). (See FHA form 2447, section 5(a)).
- iii) **Limitations of Borrower’s Obligation to Share Cost of Damages.** HUD’s minimum coverage requirements protect borrowers by limiting their obligation to share the costs of damages when a casualty occurs and by assuring that the insurance proceeds are sufficient to pay the commensurate portion of the principal amount of any insured mortgage(s) when a damaged building cannot be restored.

Typically, insurers require borrowers to share the cost of damages by one (or both) of two methods: deductibles, and co-insurance requirements. HUD limits borrowers’ exposure as follows:

- (a) Deductibles may not exceed the greater of \$25,000 or 1% of the insurable value for any particular building up to a maximum amount of \$250,000;
- (b) The borrower must purchase casualty insurance in an amount that equals or exceeds any applicable co-insurance requirement. This limitation prevents borrowers from purchasing insurance policies that require borrowers to pay a share of damages on partial claims (i.e. claims for less than total losses). A co-insurance requirement is expressed as a ratio or percentage that the maximum insured loss for any casualty event bears to the aggregate of insurable values for a property. The maximum insured loss is also commonly called the “face amount” of the insurance policy and is the insurer’s maximum obligation for damages from any casualty event. Recognizing that total losses are quite rare, especially for multi-building properties, borrowers often seek to reduce premium costs by reducing the face amount of insurance purchased. A co-insurance clause requires borrowers to share in any loss if the face amount of insurance purchased is less than the co-insurance requirement. A co-insurance requirement typically, but not always, imposed by insurers is 80%, meaning the face amount of insurance purchased should equal or exceed 80% of

insurable values. With this co-insurance requirement, if a borrower purchases a face amount of insurance which is 65% of insurable values then the insurer's obligation to pay any claim will be limited to 65% of the claim, leaving 35% (plus any deductible) to be paid by the borrower. If the borrower purchases a face amount equal to or exceeding the co-insurance requirement, then the insurer is obligated to pay 100% of any claim (less any deductible) up to the face amount of the policy.

iv) Exceptions. In some circumstances such as large properties with multiple buildings and properties included in a portfolio with multiple tiers of casualty loss coverage, a waiver of the 80% of insurable values minimum may be considered provided that the lender demonstrates the adequacy of coverage in light of possible casualty events and that the borrower is not obligated to share in losses arising from partial claims.

C. Other Insurance Requirements. Both HUD and the lender must be named as additional insured on the policies of insurance. All insurance carriers or providers which issue policies of insurance on a HUD insured project must have and must maintain during the policy period a rating that is acceptable to HUD (A.M. Best Financial Strength Rating [FSR] of B+ or better). Further detail of ongoing requirements for insurance coverage after Endorsement may be found in the Asset Management handbook (HUD HB 4350.1). The amount of property insurance required is further discussed in the Asset management Handbook.

### **3.10 Large Loan Risk Mitigation Policies**

A. Purpose.

This section defines the underwriting standards for large multifamily loans, primarily those above \$75 million. Except where otherwise stated, these policies do not apply to:

- a) loans below \$75 million,
- b) refinancing loans processed under Section 223(a)(7),
- c) refinancing or substantial rehabilitation loans for properties with rental assistance contracts covering 90% or more of the property's units, or Low Income Housing Tax Credits with actual rents at least 10% below market, or
- d) the insurance programs administered by the Office of Healthcare Programs.

B. Underwriting and Reserve Standards for Large Loans.

1. The following DSCR, LTVR and LTCR underwriting standards shall be applied incrementally as loan sizes increase:

New Construction/Sub Rehab under Sections 220, 221 (d)(4), 231, 241(a) on loans at or above \$75M:

Loan Size Limits	Affordable DSC Limits	Affordable LTC Limits	Market DSC Limits	Market LTC Limits
<\$75M	1.15	87%	1.176	85%
≥\$75M*	1.25*	80%	1.30%	75%*

\*Represents current underwriting guidance

Refinancing under Section 223(f) on loans at or above \$75M:

Loan Size Limits	Affordable DSC Limits	Affordable LTV Limits without/with cash out	Market DSC Limits	Market LTV Limits without/with cash out
<\$75M	1.176	87%/80%	1.20	85%/80%
≥\$75M*	1.25*	80%*/70%*	1.30*	75%*.70%*

\*Represents current underwriting guidance.

Projects with greater than 90% Project-based rental assistance may be underwritten at up to 90% Loan Ratio, or 1.11 Debt Service Coverage for all programs, so long as the loans amount is less than \$75 million.

2. Minimum Initial Operating Deficit (IOD) and Debt Service Reserves for Large Loans.

New construction/substantial rehabilitation projects with both a loan amount at or above \$25M should have a minimum amount of Initial Operating Deficit Reserve to help assure success of these projects during their early, most vulnerable stages of rent-up.

A minimum Debt Service Reserve is required for Large Loan Section 223(f) transaction which do not have at least 3 years of demonstrated stable occupancy and operations as well.

The following minimum Reserve amounts apply to Sections 220, 221 (d) (4) and 231 Loans (as IOD's) and Section 223(f) Loans (as Debt Service Reserves). If the amount determined under Section 7.14 of the MAP Guide "Calculating Operating Deficits" exceeds the amount shown below, the MAP Guide amount takes precedence.

Loan size	<b><i>Reserve amount based on minimum number of months of <u>amortizing</u> debt service, including MIP</i></b>
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<\$25M	Between 4 to 6 months debt service
\$25M – \$75M	9 months debt service
>\$75M	12 months debt service
>\$100M	12 months debt service, unless a higher amount is identified through HUD analysis of the risks and the mitigants appropriate to the particular loan application
	Note: for projects \$25M or more which will complete rent-up within 12 months of construction completion, the stated minimum number of months of debt service may be reduced by 3 months.

3. Loans greater than \$100 million.

Based on HUD’s analysis of the risks and the mitigants appropriate to the particular loan application, the required minimum DSCR, LTCR *or* LTVRs, and the minimum Initial Operating Deficit or Debt Service reserve requirements for loans over \$100M may be increased. Lenders should detail appropriate risk mitigants for such transactions, which will be reviewed on a case-by-case basis.

4. Eighteen (18) month Maximum Absorption Period.

The absorption period for estimating market demand is limited to 18 months. Regional Office Directors may waive the 18-month absorption period restriction only in cases where there is an unusually strong market which will support initial rent-up to sustaining occupancy beyond 18 months and where the borrower has clearly demonstrated successful experience with developing such projects in the recent past. Such projects may require larger Initial Operating Deficit or Debt Service Reserves.

5. Other Underwriting Requirements for Large Loans.

The following underwriting and mortgage credit requirements will apply to Large Loans:

i. Principal’s net worth and liquidity requirements for loans greater than \$75 million:

Principals of the borrowing entity must have, in aggregate, net worth equal to at least 20% of the loan amount and liquidity equal to at least 7.5% of the loan amount. This requirement may be waived for sponsors of subsidized affordable housing properties.

ii. Recognition of land or building value appreciation for loans greater than \$25 million:

For properties refinanced under Section 223(f), or for land or buildings contributed for development under Sections 220, 221 (d) (4) and 231, the HUD review appraiser may not recognize an increase in the appraised value above the borrower’s acquisition cost plus the direct costs incurred for property improvements, unless the borrower has owned the property for 3 years or longer as of the date of application.

For properties owned for less than 3 years as of the date of application, the recognized value of the property will be the lower of: a) the appraised value, or b) the property acquisition cost plus direct

costs incurred by the borrower for improvements to enhance or upgrade the property, such as to rehabilitate or upgrade an existing building, to obtain a zoning change, or for improvements to land such as removal of environmental hazards or improvements to infrastructure, which costs and improvements must be documented by the borrower and verified by the lender.

For properties owned for less than 3 years as of the date of application, the Regional Center Director may issue a waiver to permit recognition of an increase in the appraised value above the property acquisition cost plus the cost of improvements, only if both of the following criteria are met:

- a) The values of comparable properties located in the subject's submarket have also increased since the date of acquisition, and
  - b) The value increase is based on an increase in property NOI due to improved property operations and is not based solely on recognition of a capitalization rate that is lower than what was prevalent in the market or was applied by the sponsor at the time the property was acquired.
- iii. Experience requirements for large new construction or substantial rehabilitation projects with loans greater than \$25 million.

Large Loan borrowers must have substantial prior experience developing, constructing and owning multifamily projects that are similar in size and scope to what is proposed. Borrowers or contractors without substantial prior experience in multifamily construction, lease up and property operations, and who have not previously successfully owned or developed other large multifamily projects, will not qualify for a Large Loan under any of the Multifamily New Construction or Substantial Rehabilitation programs. Borrowers with no experience operating multifamily rental housing will not be considered for acquisition financing under Section 223(f) unless there are significant mitigants (e.g. the principals have clean credit, strong diversified financial capacity, and the property will be managed by a third party management agent with relevant and positive HUD experience, conservative valuation.)

Related experience in single family development or in development of commercial properties is not an acceptable substitute for the required prior multifamily experience and may not be a basis for a waiver of the experience requirement.

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## Chapter 4 Application Processing

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### 4.1 Introduction / General

Only an approved MAP Lender and MAP-approved Underwriter may submit an application for insurance using MAP. Lenders should contact the MF Regional Center's Workload Distribution Lead to discuss the submission of an application for insurance using MAP.

Approval of Lender's Reviewers. The lender is responsible for assigning a MAP-approved Underwriter, who is responsible for selection and management of their third party consultants. If a Regional Center or Satellite Office has concerns about an underwriter or a proposed third party consultant, they should contact the Multifamily Asset Counterparty Oversight Division before responding to the lender.

The lender must advise HUD who will be the Construction Loan Administrator prior to the Firm Commitment stage if the closing and servicing lender has been identified, or as soon as identified.

### 4.2 Stages of Application

#### A. Refinancing Applications (Sections 223(f), 223(a)(7)).

1. Concept meetings (or conference calls) with the MF Regional Center or Satellite Office are optional and generally not needed for refinancing transactions. They are recommended for projects in volatile markets, large loan requests, questions about the scope of repairs, significant cash out, if there are concerns about marketability, environment, competing proposals, for projects with significant cash out, or if there are other unusual risk factors. Upon the lender's request, the MAP Coordinator will schedule the meeting either in person or by teleconference as soon as workload permits, generally within two weeks. Site visits by the appropriate HUD staff may be conducted if practicable. Please refer to Appendix 4 for concept meeting exhibits.

HUD will respond by written letter or by email within 5 business days of the concept meeting. Consideration will be given as to the effect on other insured projects in the subject's market area that are already in the pipeline or in portfolio, developer experience and overall feasibility based on the exhibits and information presented. Depending on the completeness and quality of the submission, HUD may recommend that the lender submit an application, request additional information, or specify conditions or recommendations to consider. The written response to the

concept meeting does not represent a commitment from HUD nor that a letter of invitation will be issued, and this should be clearly stated in the response. Based on the preliminary information submitted, HUD may encourage an application submission but not approve it after review of the actual application.

2. Firm Commitment application submissions will be reviewed for completeness, processed, reviewed and underwritten and either recommended for approval or approval with conditions, returned to the lender for modifications, or rejected.
3. Loan Approval is either by National Loan Committee, Regional Center/Satellite Office Loan Committee, or Regional Director signature authority. Loan Committee requirements are specified in administrative memoranda to HUD staff.
4. Firm Commitment issuance.
5. Firm Commitment acceptance and rate lock. Firm Commitments may be extended up to no more than 180 days from date of insurance. After that time, a reopening fee of 50 basis points is required.
6. Closing.

#### B. New Construction and Substantial Rehabilitation Programs.

1. Concept meetings (or conference calls) with the MF Regional Center or Satellite Office are required for market rate new construction or substantial rehabilitation transactions (unless waived by the Regional Director) and optional for affordable transactions. The process for concept meetings is the same as for refinancing transactions. Lenders may submit applications for market rate deals without a concept meeting; however the application fee will be considered “earned” at acceptance of the application for processing and will not be refunded if the application is rejected or not approved under terms acceptable to the lender and borrower.

The lender may request to skip the Pre-application stage to go directly to Firm Commitment application. Lenders should only consider such requests for projects in strong markets, where the lender and borrower acknowledge in writing the risk of a rejection and that the application fee is nonrefundable, so long as there are no environmental issues, and the lender, borrower, and development team members have previous positive experience with FHA Multifamily financing.

2. The Pre-application stage for new construction or substantial rehabilitation is designed to permit HUD to review the feasibility of a proposed project prior to the lender, borrower, and HUD spending the time and expense involved in Firm Commitment processing. Pre-application submissions will be reviewed for completeness, processed, reviewed and underwritten, and either recommended to be approved, approved with conditions, returned to the lender for modifications, or rejected.

If an invitation letter is issued, the lender must advise HUD in writing within 30 calendar days if it plans to submit a Firm Commitment application. If it fails to notify HUD, the invitation letter will expire and the lender will be required to repeat the Pre-application process. Letters of invitation are issued and effective for 120 calendar days.

The application for a Firm Commitment must be submitted within 120 days of the date of the letter of invitation. The Regional Director may or may not authorize one extension up to 90 days. The HUD Underwriter will review the lender's extension request.

If there is a justifiable request by the lender for an extension of time beyond the time period allowed (210 total days), the Regional Director must request approval for a further extension from the Director of the Office of Multifamily Production, in HQ stating the additional time requested, the Regional Director's recommendation and the reasons for the extension.

3. Loan Approval is either by National Loan Committee, Regional Center Loan Committee, or Regional Director signature authority. Loan Committee requirements are specified in administrative memoranda to HUD staff..
4. Firm Commitment acceptance and rate lock. Firm Commitments may be extended up to no more than 180 days from date of issuance. After that time, a reopening fee of 50 basis points is required.
5. A pre-construction conference is required prior to Initial Endorsement / Closing.
6. Closing.
7. Construction period.
8. Cost Certification.
9. Final Endorsement.

#### C. Appeals.

Lenders have the right to appeal HUD decisions regarding the issuance of an Invitation for Firm Application or Firm Commitment with which they do not agree. There is no appeal process for the concept meeting recommendation. Other parties (borrowers, third parties) do not have a formal right to appeal. Appeals must be filed in writing, delivered electronically and by hard copy, to the Regional Director. The appeal must explicitly address the basis for the appeal and disagreement, and include supporting documentation and background information, including a copy of relevant previous correspondence and reports.

The Regional Director will assign the appeal for review to staff not involved in the original decision. The Regional Director will issue a written response to the Lender within 30 days of receipt of the appeal, or such other period of time as practicable. If the original decision being appealed was a result of a Regional Center Loan Committee which the Regional Director participated in, the Regional

Director will either hear the appeal or may request it be treated as a second level appeal and referred to HUD Headquarters.

If the lender is not satisfied with the appeal decision, they have the right to a second level appeal, which should be addressed to the Director of Production in HUD Headquarters. The Director will assign the appeal for review to technical support or other staff not involved in the original decision. The Director will issue a written response to the Lender within 30 days of receipt of the appeal, or such other period of time as practicable.

## **4.3 Lender Processing**

### **A. General Requirements.**

1. Borrower engagement letters are expected as a prudent business practice, but not regulated by HUD. Only one MAP lender may be engaged at a time. If a borrower changes MAP lenders prior to or after submission of an application, the borrower must disclose the processing history, and the MAP Lender submitting the application must address it in the Underwriter Narrative Executive Summary.
2. Lenders must have a written contract (engagement letter) with Third Party reviewers; HUD recommends extension clauses as part of the contract.
3. Electronic submission of applications material, Standard Underwriting Narrative, and data through the electronic “wheelbarrow” is required. Application checklists are in Appendix 4. HUD will in the future continue moving to complete electronic submission and processing through a web-based portal.
4. MAP Lenders are required to comply with the procedures and management controls specified in their Quality Control Plans.
5. Pre-Approval of Principals with Large Concentrations of FHA Insured Debt. The lender must perform a thorough mortgage credit and creditworthiness review, and obtain HUD approval, before submission of an application in cases where principals have greater than \$250,000,000 of outstanding FHA insured debt. Please refer to Section 8.8 for additional information.
6. Lenders may produce their own copies of HUD forms, so long as the recreated forms have the correct Office Management and Budget (OMB) numbers, HUD form numbers, OMB expiration dates, and approval numbers, form titles, and are identical in content and order of the line items on the MAP Form. All forms must be completed subject to their respective instructions. (See HUDClips, [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/forms](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms).)

7. A complete application submission includes one original, one additional hard copy and one electronic copy. The additional hard copy should be in a separately bound mortgage credit file, and the rest of the application containing the exhibits which do not contain sensitive personal and Privacy Act protected information. A standardized underwriting narrative and more structured application checklist are now required as well.

## B. Processing

The lender's MAP approved Underwriter is responsible for oversight and performance of the following tasks:

1. Data collection;
2. Due diligence;
3. Loan Processing;
4. Mortgage Credit review;
5. Underwriting;
6. Obtain internal loan approval (from the lender's loan committee or other process);
7. Submission of the loan application to the appropriate Regional Center or Satellite Office and the application fee to Pay.gov. See Appendix 4 for pay.gov instructions;
8. Responding to HUD deficiency letters and requests for information;
9. Follow-up to get the loan to closing;
10. Coordination with construction loan administration, cost certification, and servicing.

## 4.4 HUD Processing

### A. General Requirements.

1. Under the direction of the MF Regional Director, the HUD Underwriter is responsible for management of the application processing, review, underwriting, loan approval and closing processes, as well as coordination of turn over to Asset Management at closing.
2. HUD review is a risk based, underwriting approach. Technical compliance and processing must be correct and documented, but the primary purpose of HUD's review is to determine if the loan application is an acceptable risk to the FHA insurance fund.
3. Standard Processing Times are detailed in Appendix 1.
4. The HUD Underwriter will review all application exhibits and determine what technical reviews are necessary, if any, given the level of complexity and risk of the transaction and program type, and perform or arrange for the underwriting and mortgage credit analysis.

Risk-based processing and the single underwriter model will allow qualified underwriters to review architectural/cost exhibits, appraisals, and market analyses, and solicit the assistance of appropriate HUD technical specialists to perform additional reviews as necessary depending on the level of risk and complexity of each individual transaction. A Construction Analyst may be called upon to advise the underwriter in his or her review, or to perform a limited review or full review, as determined by the Production team. The level of review by the HUD Construction Analyst may vary but, the work required from the lender's third party provider has not changed. The MAP Lender and third party provider are responsible for determining the acceptability of the physical improvements, providing conclusions essential for underwriting determinations to minimize mortgage risk, and ensuring compliance with MAP Guide instructions and guidance. Similarly, the HUD Appraiser may be called upon to act in an advisory role or perform limited or full reviews as deemed appropriate by the HUD Production team.

5. HUD has certain responsibilities which it does not assign to the lender, including responsibility for the environmental clearance, approval of the owner's Affirmative Fair Housing Marketing program, Previous Participation review, and issuing the commitment for mortgage insurance.
6. HUD staff must perform a site visit for all applications in which an Environmental Report is required. Environmental approval is documented by HUD in the HUD Environmental Review Online System (HEROS) - Form HUD-4128. The lender and the third party consultants prepare information for HUD's review and assistance in completing the review. The form HUD-4128 must be signed by the Regional Director or other delegated authority as part of the Firm Commitment approval. The site visit is typically performed by a HUD Appraiser, Construction Loan Analyst, Senior Underwriter, or other experienced HUD staff or managers with training and experience in environmental review requirements after review of the third party and lender's environmental analysis. HUD Regional and Headquarters Environmental Officers may be called on to assist if and as questions arise.
7. Applications which the Regional Center or Satellite Office determine to be unacceptable will be returned to the lender and HUD will retain the application fee if the transaction completed screening and was put into underwriting and technical review. If it is clear at the screening stage the transaction is not approvable, it will be rejected at that stage. Lenders repeatedly submitting premature, materially deficient, or otherwise unacceptable applications should be referred to the Multifamily Asset Counterparty Oversight Division.
8. Review of MAP Lender Team Members. HUD must check the Limited Denial of Participation List and the Consolidated List of Suspended and Debarred Contractors for all proposed lender team members, and review the proposed MAP Lender and underwriter, and third party resumes. If there is a concern with past performance, the Regional Director will consult with Multifamily Asset Counterparty Oversight Division for guidance on how to proceed. If appropriate, adverse findings or conclusions should be communicated to the lender within 10 business days.

## B. Processing.

Under the direction of the MF Regional Director, Production Division Director, and Underwriter Branch Chief, the HUD Underwriter is responsible for the oversight and performance of the following tasks:

1. Concept meetings and follow-up communication;
2. Reviewing of proposed MAP Lender and Underwriters;
3. Working with the Workload Distribution Lead for the Region and other appropriate officials in managing workload assignments for new applications;
4. Acknowledging receipt of the application;
5. Ensuring the screening of applications for completeness, and fiscal controls for new application submissions;
6. Using the New Early Warning System (NEWS) to determine what level of underwriter and technical specialist review is required given the complexity and risk factors associated the transaction;
7. If during underwriting and technical review, HUD staff determines the application to be deficient, advising the lender who will have 5 business days to correct the defects or deficiencies. If the defects/deficiencies cannot be corrected within the 5 business days, or such other time frame as the Regional Director deems appropriate, HUD will preliminarily reject the application and stop processing;
8. Performing technical reviews of lender underwriting and third party reports, or arranging for HUD technical specialist reviews for higher risk or more complex transactions when needed;
9. Consulting with and obtaining reviews from Asset Management, Legal, Labor Relations, EMAD, FHEO, and other HUD staff as appropriate depending on the program requirements and particular transaction features; Recommending transactions for loan approval (or rejection);
10. Determining whether there are any open referrals to HUD's Departmental Enforcement Center (DEC) relating to the Project, the borrower and/or the proposed management agent; and working with the DEC to resolve the open DEC referrals either prior to, or in tandem with, closing.
11. Preparing and issuing Pre-application Invitation letters and Firm Commitments;
12. Coordinating the closing process with the Closing Coordinators, OGC, the lender, and borrower's team;

13. Coordinating with Asset Management in turnover of files, briefing about conditions of the Firm Commitment, and providing information necessary for Asset Management's risk rating of the transaction.

C. Construction Period Responsibilities.

1. Under MAP, HUD must approve the initial and final draws.
2. HUD will perform or contract or otherwise provide for inspection duties and will provide copies of the Trip Report to the MAP Lender.
3. The MAP Lender will prepare and approve the documents required for the interim draws during construction.
4. HUD must approve the construction amount for each item in the initial and final advance and for each Change Order during construction.

D. Servicing.

MAP makes no changes in procedures for servicing or asset management, except for servicing lenders with prior approval for delegated responsibility for repair escrow administration. See Section 1.2 above for guidance on MAP-approved lenders who only originate loans and transfers the loan to another FHA-approved lender for servicing.

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## Chapter 5 Architectural & Construction Analysis

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### 5.1 Classification of Work and Eligible Construction Activities

Construction activities eligible for insured mortgage programs are described in terms of costs and scope for two purposes. The first purpose is to determine eligibility of the construction activity by program, i.e., by Section of the National Housing Act. The second is to identify what design documentation, construction supervision and management, and work inspection methods are most appropriate to the proposed work.

#### A. Classification of Work.

Classification of work is an important aspect of scope. Construction activity is either new construction (erecting buildings not previously in existence) or some level of work on existing structure(s). The class of work with the largest scope is “new construction.” Classes of work on existing structures are defined in the International Building Code for Existing Structures (2012, Chapter 5). These classes of work, in order of scope from least to greatest, are:

1. **Repair:** “The restoration to good or sound condition of any part of an existing building for the purpose of its maintenance.” (IBC, Section 202) *Repairs to site features (not buildings but otherwise similarly defined) are included in this class of work.* “Repairs include the patching or restoration or replacement of damaged materials, elements, equipment or fixtures for the purpose of maintaining such existing components in good or sound condition with respect to existing loads or performance requirements.” (IBC, Section 502) Repairs also include related work. Related work is “work on non-damaged components necessary to accomplish the required repair of damaged or deficient components.” (IBC Section 502.3) *In addition, installation of items not previously present in a building or on a site but necessary to address safety, security, accessibility or communications needs are considered repairs when such installation and related work does not require alterations. Examples of such installation include but are not limited to smoke detectors added to bedrooms, signage or pavement markings added to identify accessible paths, panic bars added to exit doors, etc.*
2. **Level 1 Alterations:** “The removal and replacement or the covering of existing materials, elements, equipment, or fixtures using new materials, elements, equipment, or fixtures which serve the same purpose.” (IBC Section 503.1)

3. Level 2 Alterations: “The reconfiguration of space, the addition or elimination of any [*exterior*] door or window, the reconfiguration or extension of any system, or the installation of any additional equipment. (IBC Section 504.1)
4. Level 3 Alterations: “Alterations where the work area [*consisting of all reconfigured spaces*] exceeds 50% of the aggregate area of the building.” (IBC Section 505.1)

## B. Building Systems.

Program eligibility for a scope of work may also be determined by the replacement of building systems.

1. For purposes of determining program eligibility, there are five building systems:
  - a. Structural frame, including foundations, load bearing walls, floor frame, and roof frame;
  - b. Building envelope, including exterior moisture and weather proof membranes, roofing, cladding, siding, windows and exterior doors and openings;
  - c. Mechanical, including heating, ventilating and air conditioning equipment and related fuel supply or exhaust items, as well as specialized mechanical apparatus such as elevators and escalators;
  - d. Electrical, including all electrical appliances (not mechanical) and lighting fixtures, electrical supply lines and panels, breakers, warning systems, and telecommunications and related equipment.
  - e. Plumbing, including all potable water, grey water, and sanitary waste lines, valves, pumps, controls, and fixtures.
2. A system is considered ‘replaced’ when the costs of replacement work equal or exceed 50% of the cost of replacing the entire system. In the case of properties with multiple buildings, “entire system” refers to the referenced system in all buildings.

## C. Eligible Construction Activities by Program.

1. Section 223(a)(7): Repairs and Level 1 Alterations are permitted provided that they do not exceed routine maintenance, (See Chapter 9.1 Subsection A, paragraph 5.) Work requiring environmental review is not permitted for Section 223(a)(7) applications. In no event shall the aggregate costs of such repairs and alterations (exclusive of those required to make properties accessible for persons with disabilities) exceed \$1,500 per unit.
2. Section 223(f): Repairs and Level 1, Level 2 and Level 3 Alterations are permitted provided that the aggregate of all such repairs and alterations is not substantial rehabilitation as defined below. Additions (meaning expansion of a building footprint with conditioned space) are not permitted to residential buildings. (Adding a patio or a balcony is considered a level 2 alteration) Additions to accessory buildings or additions of minor accessory structures (e.g. carports, storage sheds,

swimming pools) may be deemed level 2 or 3 alterations subject to the approval of the Director of the Regional Center/Satellite Office;

3. Sections 220, 221, 231, 241(a): new construction and all repair and alteration activities are permitted.

#### D. Substantial Rehabilitation.

Substantial rehabilitation is any scope of work described for existing buildings of a property where the scope:

1. Exceeds in aggregate cost a sum equal to the base per dwelling unit limit times the applicable High Cost Factor times the number of dwelling units proposed for the property after completion of any construction; or
2. Replaces two or more building systems.

The base per dwelling unit limit was established at \$6,500 in 1983 and is now obsolete because of inflation in construction costs over the past 30 years. The base limit is revised to \$15,000 per unit, and will be adjusted periodically based on the percentage change published by the Consumer Financial Protection Bureau or other inflation cost index published by HUD. In this context, “aggregate cost” means all costs reported (or which, if known, would have been reported) on HUD form 2328 Contractor’s or Mortgagor’s Cost Breakdown, including any used contingency or assurance of completion. The lender must assure that the cost of repairs and alterations in refinance transactions does not exceed the program eligibility limit notwithstanding any unforeseen circumstance or construction estimating error. (See Section 5.11, subsection D, paragraph 4 for eligibility of fees paid or payable to identity of interest participants).

#### E. Extent of Substantial Rehabilitation: Gut Rehabilitation.

For some purposes (e.g., defining the scope of work for a CNA or benchmarking utility consumption) the extent of substantial rehabilitation must be further analyzed to determine when past building performance is relevant for predicting future results. When a rehabilitation scope of work retains little more than the structural frame of a building (“gut rehabilitation”), the past performance of the existing building is of limited relevance. Estimates of future results should be based on proposed plans and specifications, as in new construction. When the property is composed of a single building, gut rehabilitation is defined as Level 3 Alterations. When there are multiple buildings, gut rehabilitation is defined as Level 3 Alterations in buildings that include 75% or more of the total building area of the property.

#### F. Substantial Rehabilitation: Section 223(f)-- Three Year Rule Look-back.

Section 223(f) applications for uninsured projects are subject to the three year rule, i.e., projects are ineligible if the property was constructed or substantially rehabilitated within three years of application. For these projects it may be necessary to analyze the extent of rehabilitation retrospectively. Owners of existing properties often complete repairs and alterations as part of ongoing capital replacements or to maintain or upgrade properties in preparation for a capital

transaction. If these repairs and alterations exceed the thresholds described in paragraph D above, a property is not eligible for Section 223(f). When applying the thresholds retrospectively, exclude:

1. Repairs and alterations completed prior to three years before the date of application; and
2. Repairs and alterations that would normally occur at the property as capital replacements reimbursable from a Reserve for Replacement Escrow.

Include all work authorized by a building permit or construction agreement that describes a scope of work exceeding the thresholds when any portion of that authorized work was completed after the beginning of the three year look back period even if the date of the building permit or construction agreement preceded the look back period.

## **5.2 Qualifications, Responsibilities, and Approval of Due Diligence Consultants**

### **A General.**

The lender and the borrower are required to retain competent third party consultants with skills, training and experience appropriate to the scale and scope of the physical characteristics of the property, the nature of architectural and engineering documents required, the kinds of construction solutions existing or proposed, and the due diligence typical of multifamily real estate transactions. In the context of this Chapter 5 the term “due diligence” is not a standard of behavior but a generic term for the range of professional examinations, studies, inquiries, research reports and investigations needed to determine the physical condition, utility and suitability of sites and buildings existing or proposed for multifamily properties.

Historically, HUD required lenders to retain either a construction analyst (aka “architectural analyst” and/or “cost analyst”) to review the project architect’s plans for new construction and substantial rehabilitation applications, or a needs assessor to prepare a capital needs assessment or CNA for refinancing applications. Borrowers were required to retain the services of the project architect. Policy changes initiated in this edition of the MAP Guide change the mix of consultants required by program and by class work. These changes are;

1. The required preparation of capital needs assessments for all applications;
2. The required use of a project architect to prepare construction documents for refinancing transactions that include certain categories of work or dollar values of repairs and alterations;
3. The required evaluation of utility consumption for most properties, and;
4. The required documentation of energy conservation measures (ECMs, aka “energy efficiency measures or EEMs) for properties with energy scores below prescribed minimums.

While the lender may retain (or require the borrower to retain) a variety of specialists when needed, the primary consultants are the lender’s construction analyst, the lender’s needs assessor, the project architect retained by the borrower, and the energy professional who may be retained by any of the other participants. (The duties, responsibilities and qualifications of the project architect are described in Section 5.3 of this Chapter.)

Whenever a borrower is required to retain a project architect, the lender is also required to retain a qualified construction analyst unaffiliated with the project architect to review the work of the project architect. In general a consultant may not both prepare and review the same due diligence product, and in particular, a single consultant may not serve as both project architect and construction analyst. When a project architect is not required for a transaction, the needs assessor and construction analyst roles are typically combined and the lender underwriter reviews the work of the needs assessor. The needs assessor may prepare dimensioned sketches or diagrams when needed to illustrate particular repairs and alterations, a service particularly useful to describe remedies for accessibility deficiencies.

Energy professionals generally have experience and training similar to other architectural and engineering and construction consultants, but also have more narrowly focused skills and qualifications that are evidenced by recognized certifications. Subject to the requirement that no consultant may review their own work and that the energy professional must have recognized certification, any consultant may verify utility consumption data and provide energy audit services. Energy professionals may be retained by either the lender or the borrower, and verification of utility consumption data and energy audits are services that the needs assessor or the project architect may provide.

## B. Scope of Work, Duties and Qualifications for Lender's Consultants.

### 1. Construction Analysts.

#### a. Qualifications.

The lender must hire a qualified construction analyst(s) with experience in multifamily construction to review the drawings and specifications prepared by the project architect and any related agreements for design and/or construction services. The analyst must be knowledgeable and experienced with local building standards and construction methods, relevant national or international building codes and standards (e.g., International Existing Building Code, International Energy Conservation Code) and specific statutory or regulatory requirements for multifamily housing (e.g., Federal Fair Housing Act Accessibility Guidelines and the Uniform Federal Accessibility Standards, UFAS). In all cases the lender must assure that the work experience of the construction analyst is consistent with the scale, scope, materials, methods and technologies proposed for or existing at the property.

The lender's construction analyst should be a licensed or registered architect or physical engineer but must, at a minimum, have a degree (BS or BA) in architecture, civil or structural engineering or construction with five years of experience in design, construction, or development of multifamily buildings. Alternatively any person who is a construction contract administrator with a current certification (CCCA) by the Construction Specifications Institute (CSI) and who has administered construction of not less than three multifamily properties with an aggregate construction cost not less than \$30 million may serve as a construction analyst.

b. Scope of Work, Duties and Responsibilities.

The construction analyst must:

- 1) Visit the site and its environs investing time and attention sufficient to support a knowledgeable and professional review of the due diligence requirements and products as well as the design, specification and construction documents to be prepared;
- 2) Evaluate the design of proposed and/or existing buildings and the construction materials, methods or technologies employed in the buildings;
- 3) Review the borrower's required architectural services (See Section 5.3);
- 4) Evaluate the professional qualifications and experience of the borrower's design and construction team members and any due diligence professionals or contractors retained by the borrower to assure conformance to HUD requirements and relevance of qualifications and experience to the anticipated scope work;
- 5) Determine that the borrower's and project architect's due diligence concerning physical attributes of the site or of existing buildings is sufficient to expose and quantify such costs and risks as may be reasonably expected based on observed conditions and identifies any unmet due diligence needs;
- 6) Evaluate architectural design, specification, construction contract, and cost and scheduling documents for proposed projects and assure internal consistency, accuracy, reasonableness, and conformance to HUD requirements, including specifically: the Minimum Property Standards; local codes and the HUD minimum energy conservation code when this code exceeds local codes; accessibility requirements for persons with disabilities; and HUD standards for architectural drawings and specifications (See Appendix 5);
- 7) Review the project architect's certification that the project design complies with the Minimum Property Standards, all applicable local codes and ordinances, accessibility requirements, and HUD standards (See Appendix 5);
- 8) Prepare a complete cost analysis and review and confirm the reasonableness of borrower's costs for design, specification, construction, contract administration and supervision (and any related due diligence or other professional services) for the construction, alteration or repair of multifamily structures;
- 9) Evaluate the professional liability and errors and omissions insurance for the project architect and borrower's other design or due diligence professionals by comparing the risks covered and the dollar amount of loss coverage to the scale and cost of construction and/or evident risks, offering an opinion of the adequacy of such coverage and confirming that such insurance will be maintained through any warranty inspection period following endorsement;
- 10) Maintain a dated log of all contacts, messages and conversations with the project architect and the borrower's design team referencing all documents and version thereof in the log;
- 11) Ensure that all relevant parties are informed of HUD requirements and communications and coordinate responses thereto;

- 12) Prepare or review the schedule of anticipated future capital needs and corresponding estimates of costs;
- 13) Review and confirm as part of the CNA the accuracy of estimates of replacement cost (new) for each structure (HUD form 92329).
- 14) Identify, review and describe to HUD any identities of interest among any members of the design, construction and/or due diligence team or between any such member and any principal of the borrower or between any such member and the lender; and
- 15) Provide advice and assistance on design, construction and physical due diligence issues to borrowers, consultants, contractors and others.

**NOTE:** Construction analyst(s) must apply the specific standards or criteria enumerated in the Appendices to this Chapter 5. The construction analyst is not required to review structural design details and calculations.

## 2. Needs Assessors.

### a. Qualifications.

The lender must select a needs assessor it determines to have education, professional credentials and field experience appropriate to the assessment assignment considering the age, size, type of building systems, construction methods, and location of the property. In no event may the qualifications of the needs assessor and any related consultants employed to prepare the CNA be less than described in ASTM E 2018-08 Appendix XI.1. The needs assessor (and any other consultants, specialists or trades contractors engaged for purposes of the needs assessment) may have no identity-of-interest with the lender or the borrower or its principals, and may not have any personal or business relationship with the borrower, or its principals that would create a conflict of interest.

### b. Scope of Work, Duties and Responsibilities.

The needs assessor always prepares the CNA for existing improvements in refinancing transactions. CNAs for new construction or gut rehabilitation proposals may be prepared by the project architect or by the lender's construction analyst. Proposals for substantial rehabilitation but not gut rehabilitation require a CNA for existing improvements, in which event, the borrower's project architect may prepare the CNA in lieu of a needs assessor retained by the lender. Otherwise, CNAs for existing improvements must be prepared by an independent, third party, needs assessor hired and paid by the lender. On-site physical inspection including a representative sampling of units is required. Capital needs assessments must be prepared in accordance with the instructions at Appendix 5G.

## C. Energy Professionals.

All applications for insured mortgages must provide verified utility consumption data for energy and water use, either for a prior 12 month year (no half or partial months) or for the projected 12 month year following completion (assuming underwritten occupancy). Such verified data must be entered in Portfolio Manager, a free tool provided by the Environmental Protection Agency (EPA). Properties with energy scores below a minimum threshold are subject to further requirements to identify utility

conservation measures by means of an ASHRAE Level II energy audit and in some cases implementation of cost beneficial conservation measures is required. (See Appendix G Section IV for detailed instructions and exceptions.) The required verification of utility consumption data, and preparation of an energy audit when necessary, must be by persons with not less than 3 years work experience evaluating utility consumption in multifamily buildings and with appropriate professional certifications or credentials including one or more of the following:

1. Registered architect;
2. Licensed professional engineer;
3. American Energy Engineers Association's Certified Energy Manager (CEM) or Certified Energy Auditor (CEA) designations;
4. American Society of Heating, Refrigerating and Air Conditioning Engineers (ASHRAE) High Performance Building Design Professional (HPBDP) designation;
5. Building Performance Institute (BPI) Multifamily Building Analyst (MFBA) designation;
6. Residential Energy Services Network (RESNET) Home Energy Rating System (HERS) Rater.

D. Specific Qualifications, Requirements for Other Technical Specialists.

The borrower, the project architect or the lender may require the services of other technical specialists to inform the preparation or review of plans and specifications. These specialists may include mechanical, structural, sanitary, geo-technical or civil engineers. When engaged for services, a principal of the technical specialist firm must be a licensed or registered professional, must sign any resulting report or opinion and when applicable must affix his/her professional seal.

E. HUD Approval of Qualifications.

The lender should disclose the identity and qualifications of both the borrower's and its own architectural and construction consultants, needs assessors, energy professionals or other technical specialists at times consistent with efficient completion of due diligence and design work but in no event later than the application for Firm Commitment. HUD reserves the right to examine credentials and experience and to reject individuals it deems unqualified for a particular assignment. Accordingly the risk of relying on due diligence or design products prepared by unqualified consultants is borne by the lender and the borrower.

### **5.3 Required Design Services and Documentation by Construction Activity and Program.**

A. Required Professional Services by Activity.

The borrower must provide or engage professional design and construction expertise for the preparation of construction documents as appropriate for proposed construction activity that exceeds the thresholds described below. Professional design services may be provided by licensed or registered architects or professional engineers, one of whom must be the principal or lead design professional with overall responsibility for the preparation of drawings and specifications and related

documents (the construction documents.) This professional is the project architect. The level of professional services and the required documentation are determined both by the classification of work proposed as well as the program for which application is made. The extent of design services and documentation needed by program and class of work are generally summarized in the following table:

PROGRAM	CLASS OF WORK*	SERVICES AND DOCUMENTS		
		CNA**	DESIGN	CONSTRUCTION
223(a)(7)	Repairs & Level 1 Alterations not exceeding routine maintenance and <=\$1,500 per unit	Required	n/a	List of Immediate Repairs/Costs, bids for trade or component items >\$25k, dimensioned sketches of accessibility remedies, and work by qualified tradesmen
223(f)	Repairs & Level 1 Alterations <\$15,000/unit***	Required	n/a	Same as above
223(f)	Level 2 Alterations or any repairs and alterations =>\$15,000/unit***	Required	Project Architect	Itemized Repairs/Costs, Dimensioned drawings of reconfigured spaces, GC & HUD 2328 needed as determined by Project Architect
223(f)	Level 3 Alterations	Required	Project Architect	Itemized Repairs/Costs, Dimensioned drawings of reconfigured spaces, GC and HUD 2328 required for Level 3 Alterations
220,221,231, 241(a)	All classes of work	Required	Project Architect	Full drawings and specifications, Architect administration of work, GC & HUD 2328, Davis-Bacon wage standard

\* More than one class of work may apply to a building or a property. When construction costs are less than \$15,000 per unit, requirements for Level 2 and 3 Alterations apply to the buildings or spaces where the alterations are proposed (not all buildings or spaces). When Level 2 Alterations are singular or very limited (e.g., alter a single space or interior, non-bearing wall) professional design services are not required..

\*\* See Appendix 5G for how CNAs are used by class of work and program.

\*\*\* This \$15,000 per unit limit for the cost of all repairs and alterations is only a trigger for when the borrower must retain a project architect; it is different from the dollar-per-unit threshold for defining substantial rehabilitation and is not adjusted for the High Cost Factor.

## B. Licensing and Insurance for Design Professionals.

### 1. New Construction, Substantial Rehabilitation.

- a. Design professionals providing required design or construction services must be professionally licensed or registered to render services in the design of buildings by the State in which the project is to be constructed.
- b. Design professionals providing required design and/or construction services must each be covered by a policy of professional liability, errors and omissions, insurance in an amount consistent with the risk of loss based on the scope, scale and cost of the product designed.
- c. The professional liability insurance policy must be maintained through the twelve month warranty inspection period that follows Final Endorsement. The professional liability insurance carrier must have and maintain a rating that is acceptable to HUD (A.M. Best Financial Strength Rating [FSR] of B+ or better).
- d. At initial closing, each design professional must provide their certificate of liability insurance which must substantially conform to the sample Certificate of Professional Liability Insurance contained in Appendix 5H.3.

### 2. Level 3 and/or Level 2 Alterations in Section 223(f) Transactions.

When the services of a project architect are required to address any combination of repairs and alterations equal to or greater than \$15,000 per unit or Level 2 and/or Level 3 Alterations, the project architect must meet the same licensing and insurance requirements as for substantial rehabilitation, including the provision of a certificate of liability insurance which must substantially conform to the sample Certificate of Professional Liability Insurance contained in Appendix 5H.3. If the project architect is retained to address Level 2 and/or Level 3 alterations where the cost of all repairs and alterations does not exceed the \$15,000 per unit threshold, the project architect may limit contract responsibilities and liabilities to the specific Level 2 reconfigured spaces or to buildings where the Level 3 Alterations occur. But when costs per unit equal or exceed \$15,000, the project architect's responsibilities and liabilities apply to all alterations and repairs.

### C. Evaluation and Selection of Project Architect.

HUD, the borrower and the lender must determine that the project architect is capable and qualified.

1. The lender's construction analyst:
  - a. Will review the project architect's experience in light of the scale, content and construction technologies required for the project and compare the project architect's experience to the nature of the proposed work;
  - b. Will monitor and review the project architect's progress on the project and the resulting design products; and
  - c. May recommend that the borrower select another professional if the project architect's past work experience or current work progress or work product(s) are found to be unacceptable.
2. Failure of the borrower to engage a project architect acceptable to the lender and HUD is a basis for rejection of the application.

### D. Owner-Architect Agreement.

On projects requiring a project architect, an agreement between the project architect and the owner for architectural services must be executed.

1. The owner must provide and the lender must submit the agreement not later than with the application for Firm Commitment.
2. For new construction and substantial rehabilitation projects the agreement must be an AIA Document B108, Standard Form of Agreement between Owner and Architect for Housing Services and must include the HUD Amendment for Federally Funded or Federally Insured Projects (HUD 92408-M).
  - a. The scope of services shall provide all architectural, structural, mechanical, electrical, civil, landscape and interior design and consulting services necessary to prepare drawings, specifications and other documents setting forth in detail the requirements for construction of the project. The scope of services shall also provide for administration of the construction contract.
  - b. The scope of services must designate the responsibility for the services to be provided, whether by the project architect, owner or others.
  - c. Additional Owner-Architect Agreements must be submitted for any part of the basic design services with more than one prime professional, e.g. for site, civil, mechanical, electrical engineering services, etc., or supervisory architectural services. The project architect is responsible for coordinating multiple prime professional contracts.
  - d. There may be separate agreements for design and construction administration services if the same project architect is not employed for each (e.g. when the project architect has an identity of interest with the borrower). When there is a separate agreement for administration of the construction contract, it must be submitted for approval before initial endorsement. Where separate agreements are made, those sections not applicable shall be deleted.

- e. The project architect may have an identity of interest with the owner or general contractor, but in that event cannot administer the construction contract. An identity of interest is defined in the HUD Amendment.
3. For Section 223(f) transactions that include repairs and alterations exceeding thresholds identified for levels of work requiring a project architect the Owner-Architect Agreement shall be an AIA form B104 for projects of limited scope.
    - a. The agreement must describe the actual services to be provided and include all services that are necessary to the project.
    - b. The project architect's fee must be a fixed sum and may be allocated among specific services.
    - c. The lender's construction analyst shall review the agreement to assure that proposed services are sufficient and clearly defined and that the borrower's right and power to assign the agreement to or for the benefit of the lender is not impaired.
    - d. There is no standard HUD amendment prescribed for the AIA B104.
    - e. The project architect may be a principal or an employee of the borrower or of an affiliate of the borrower provided that requirements for professional qualifications, licensing or registration, and professional liability insurance are met and that the construction documents produced are not diminished by comparison with what would otherwise be required in the AIA B104 and no architect's fee payable to the affiliated principal or employee shall be a mortgageable cost. In this event, no Owner-Architect agreement would be required but HUD or the lender may require construction administration by a separate, unaffiliated, qualified design professional and in that event the AIA B 104 would be executed to retain those services. The borrower and/or its affiliates must demonstrate an established, successful history of self-performing architectural design services composed of multiple successful projects comparable to that proposed.
- E. Modification of B108 Owner-Architect Agreement for New Construction and Substantial Rehabilitation. The document may be changed to reflect the actual agreement between owner and project architect for the specific project.
1. Generally modifications can be made by striking out inapplicable provisions and inserting additional provisions in Article 12. Adding directly to a specific provision is also acceptable.
  2. Changes by either the project architect or owner, shall not delete any service necessary to the project, although the responsibility for a required service may be transferred.
    - a. The document shall provide a clear and definite statement of how responsibility for providing any required service is to be divided between project architect, owner and others. Documents must conform to requirements in Section 5.3.D.2 above.
    - b. Required services may not be sublet or delegated to any one not identified to and approved by HUD.
  3. The project architect's fee must be a fixed fee for the services provided as stated in the Agreement. No other method of stating compensation is acceptable. Separate fee amounts for design services and for construction services must be stated.
  4. Where the project architect's basic fee exceeds that which may be paid from mortgage proceeds or where the Owner-Architect Agreement provides for reimbursable expenses (note that reimbursable

expenses may not be paid from mortgage proceeds), the person/entity responsible for such extra fees must be identified on the HUD Amendment.

5. HUD shall not be incorporated into any specific provision of the Agreement and the inclusion of the HUD Amendment in Article 12 (enumeration of Special Terms and Conditions) is sufficient to incorporate HUD requirements. No modification of the HUD Amendment is permitted.
  6. The lender's construction analyst must review the agreement for compliance with these instructions.
- F. Architectural Considerations in Industrialized Housing (New Construction). The lender's construction analyst must contact the Production Chief of the Multifamily Regional Center or Satellite Office to approve the use of industrialized (aka "modular") housing. Architectural and engineering services are required for off-site construction of housing (modules or panels) and the fees for such services must be included in the cost of each manufactured unit. The lender's construction analyst must determine the acceptability of such services by examining the drawings and specifications. In addition architectural services are required for on-site construction including site work and a prepared foundation for the installation on-site of modules or panels constructed off-site. These services are provided by the project architect.
1. The exhibits for off-site work shall be equal in quality to the typical construction documents prepared by architects engaged in designing the type of housing proposed and should include the working drawings and specifications for the typical industrialized housing unit, along with an assembly or installation plan and manufacturer's warranty document which must cover not only off-site construction but also transit and delivery and the efficacy of the on-site assembly or installation plan.
  2. Additional professional services may be required to provide a complete set of construction documents. These services must be determined by the lender's construction analyst for each project based on the percentage of the construction documents for the project that may be provided by the housing manufacturer. Usually, the project architect will integrate the manufacturer's drawings into his/her set of drawings and specifications, adapting them to the particular project.
  3. The manufacturer shall provide complete professional design services for the modules or panels to be used. If these services in combination with those of the project architect meet in all respects the qualifications and quality required, the construction documents shall be acceptable.
  4. In most states, plans and specifications for industrialized or manufactured housing are pre-approved by an authorized state office, agency or building code official with plans for particular models evidenced by a plan approval number. Inspections and or certifications of factory based construction typically are managed by states by periodic factory inspections evidenced by stamps and/or numbered approvals. It is the responsibility of the project architect, reviewed by the lender construction analyst, to determine that any and all plan approvals have been obtained.
  5. Owner-Architect Agreement, AIA Document B108, is required only to cover the services provided by the project architect and is not required for professional services provided by the housing manufacturer.
  6. In all cases, an independent architect with no identity of interest shall provide general administration of the construction contract.

## **5.4 Architectural Standards and Other Criteria**

Projects that are built, substantially rehabilitated, acquired or re-financed with FHA mortgage insurance must meet the standards described in the Appendices to this chapter, as outlined below:

- A. Appendix 5A – Common HUD Standards and Criteria
- B. Appendix 5B – Accessibility for Persons with Disabilities
- C. Appendix 5C – Seismic Resistance and Fire Protection Standards for Existing Buildings
- D. Appendix 5D – Energy Codes
- E. Appendix 5E – Firm Commitment Drawings and Specifications to be Submitted by the Borrower’s Architect
- F. Appendix 5G– Capital Needs Assessments

## **5.5 Construction Contracts**

New construction and substantial rehabilitation projects always require a general contractor and a HUD form of contract (HUD 92442-M) and Supplementary Conditions to the Contract for Construction (HUD 92554-M). Section 223(f) transactions with Level 3 Alterations require a general contractor to execute an owner-contractor agreement covering at a minimum the Level 3 Alterations, if not necessarily all other repairs and alterations. For 223(f) transactions with any combination of repairs and alterations with costs equal to or exceeding \$15,000 per unit or with Level 2 Alterations, the project architect shall determine whether the scope of work requires a general contractor. Whenever a general contractor is engaged, the owner-contractor agreement must be in writing and in a form acceptable to HUD. Construction contracts acceptable to HUD are as follows:

- A. New construction and substantial rehabilitation. The owner-contractor agreement (the general contract) shall be HUD form 92442-M with Supplementary Conditions to the Contract for Construction, HUD form 92554-M. These forms are coordinated with Owner Architect form B108 and the HUD Amendment to the B108 (HUD 92408-M) as well as with other HUD forms referenced in the Owner Architect and the Owner Contractor agreements. In addition, new construction and substantial rehabilitation projects require use of the Building and Loan Agreement between the borrower and the lender (HUD 92441M.).
- B. Section 223(f) transactions. The AIA A107 form of Owner Contractor agreement is paired with the AIA B104 and must be used. Other AIA forms for change orders, requisition of funds and related processes referenced in these paired agreements should also be used in accordance with the terms of the agreements.

## **5.6 Streamlined Processing Instructions For Projects Requiring Professional Design Services**

Streamlined processing of architectural design, specification, construction, and cost estimation exhibits serves two purposes. The first is to expand use of HUD mortgage insurance programs for projects with Low Income Housing Tax Credits (LIHTC). The second is to expedite applications for borrower development teams with clearly demonstrated capacity and experience with HUD insured construction projects. Streamline processing means that less than 100% complete plans and specifications may be submitted with the application for Firm Commitment. Proposed final project drawings and specifications must be submitted for HUD review and comment/approval at least thirty calendar days prior to initial endorsement. Any HUD comments on the proposed final drawings and specifications must be resolved and permit ready drawings and specifications (approved by the Building Code Official with jurisdiction, subject only to the payment of required permit fees and charges) must be delivered not less than ten calendar days prior to initial endorsement.

### **A. Applications Eligible for Streamline Processing.**

All LIHTC project applications are eligible for streamline processing of design and construction documents. Other applicants should describe and discuss their qualifications for streamlined processing with the MF Regional Center/Satellite Office at the concept meeting or pre-application stage. To be considered qualified the borrower/sponsor, the project architect, the general contractor, if any, and due diligence providers, must each have successful prior HUD project experience comparable in scope and scale to the scope of work proposed in the application. Generally, HUD will determine eligibility for streamline processing as a result of a concept meeting or pre-application. Applicants for 223(f) without LIHTCs and with repairs and alterations requiring a project architect may request a concept meeting if they consider deferred submission of final plans and specifications useful. Otherwise 223(f) applicants should provide final plans and specifications with the application for Firm Commitment.

### **B. Other Factors Limiting Streamline Processing for Non-LIHTC Applications.**

Lenders and MF Regional Center/Satellite Offices should determine that the project will achieve initial closing within sixty calendar days after issuance of a Firm Commitment conditioned upon final plan submission. Lenders and MF Regional Center/Satellite Offices should also consider the complexity of the proposed design and construction when determining whether to permit the deferred submission of final drawings and specifications. Complex issues unsuited to streamlined processing include, but are not limited to:

1. Any claim of exemption from the design and construction requirements of the Fair Housing Act based on site impracticality (terrain unsuited to accessible paths and building entrances);
2. Projects where costs not attributable to residential use must be calculated because Criteria 4 of the form HUD 92264A, Statutory Limitations of cost per family unit is material to the calculation of the maximum mortgage amount;

3. Projects with complex mixed use, commercial use, or use of new, complex construction technology;
4. Projects with complex environmental remediation issues or with historic preservation objectives.

C. Minimum Construction Documentation at Firm Commitment.

The Firm Commitment may be conditioned on the timely receipt and satisfactory review of complete and final plans, specifications and cost estimates, provided that the lender's submission of less than 100% of the drawings, specifications (i.e., schematic/line/working drawings) and cost estimates provides the following detail:

1. The static footprint of the building or buildings together with proposed site improvements on the surveyed site plan as well as any proposed easements and/or off-site improvements with survey detail consistent with the requirements for surveys described in Appendix 5A. ;
2. The gross building and net residential square footage for the project;
3. Dimensioned unit layouts for each unit type for new construction or substantial rehabilitation or for reconfigured spaces in Section 223(f);
4. Dimensioned floor plans, and elevations for each building type;
5. Sufficient design detail to determine the Davis-Bacon wage rate classification for new construction and substantial rehabilitation;
6. Sufficient design detail to determine compliance with accessibility requirements in Appendix 5B;
7. Sufficient design detail (wall cross section details) to determine structural framing and exterior wall finishes for new construction and gut rehabilitation and other repairs and alterations when applicable;
8. A summary interior finish schedule identifying proposed interior finishes for units, including kitchens and baths, as well as for building common spaces and accessory structures;
9. Sufficient design detail to determine building mechanical systems;
10. Sufficient design detail to determine scope of site development and off-site construction;
11. A written cost estimate (HUD-2328) from the general contractor, if any;
12. The lender's construction analyst's cost estimate (HUD 92326) for new construction and substantial rehabilitation or review of repair and alteration costs for Section 223(f);
13. The lender's review and comparison of the general contractor's cost estimate with the lender construction analyst's estimate on form HUD 92331 for new construction and substantial rehabilitation;
14. For new construction and substantial rehabilitation (a) the proposed but unsigned owner contractor agreement for construction (HUD 92442M) indicating any selected options (e.g. incentive

payments, etc.) or special conditions and the Supplemental Conditions (HUD 92554M). For Section 223(f), the AIA A107, if general contractor is used;

15. Project Architect's or needs assessor's CNA reviewed by the lender's construction analyst with the lender's financial plan for funding future capital needs, all in accordance with Appendix 5G;
  16. A HUD Custom Statement of Energy Design Intent (for new construction or gut rehabilitation) or a HUD Custom Statement of Energy Performance (for existing buildings with less than gut rehabilitation) obtained from the Environmental Protection Agency's Portfolio Manager application, verified by the energy professional and attached to the CNA by the lender at submission as described in Appendix 5G; and
  17. For gut rehabilitation, the project architect's detailed inspection report and work write-up.
- D. Scope of HUD Review and determinations required in order to issue a Firm Commitment:
1. An assessment that the estimated project cost based on the borrower's or general contractor's estimate of costs and the lender's cost estimate and the lender's comparison of these estimates is reasonable and in line with comparable HUD project data and is likely accurate within a deviation of plus or minus 5%;
  2. An assessment that the borrower's and general contractor's financial capacity to complete the proposed construction is not materially diminished by an increase in cost of up to 5%;
  3. An assessment that the proposed general contractor is acceptable pursuant to existing requirements (sufficient working capital, experience, etc.); and
  4. An assessment that the plans and specifications are in compliance with all applicable requirements on a preliminary basis, with appropriately qualified certifications executed.
  5. The Phase I (ASTM Practice E 1527-13 or most current) environmental site assessment and the HEROS - form HUD 4128 must contain no significant unresolved environmental issues.
- E. A modification must be made to the Firm Commitment for those projects determined to be eligible for deferred submission of final drawings, specifications and cost estimates. Below is a sample special condition to be added to the Firm Commitment.

*“As an accommodation to the Borrower, this commitment has been issued and based upon preliminary drawings, instead of the final drawings, specifications and cost estimates. At least 30 days prior to the scheduled date for Initial Endorsement [Endorsement, if pursuant to 223(f)], HUD must receive the final drawings, specifications and the lender's architectural/cost review report for review and approval to ensure consistency of design and cost. In the event that there is a net cumulative construction cost change of more than 5%, or a change in design concept, this commitment shall be subject to and conditioned upon the further approval of HUD, to be evidenced in writing. Based on such review this commitment may be terminated and voided by HUD, or additional conditions may be imposed, at HUD's option.”*

- F. All risks related to deferred submission of construction documents are borne by the lender and the borrower. HUD will not refund application fees in the event that borrower is unable to provide acceptable construction documents.

## **5.7 New Construction, Standard Processing- Concept Meeting through Firm Commitment Application**

- A. Concept Meeting. When a concept meeting is scheduled, its purpose with respect to design and construction topics is to establish feasibility and to identify key issues. For this reason the lender should provide:
1. The name, address, contact information and resume or summary of experience of the project architect and any other design professional(s), due diligence providers and the general contractor if known. Of particular importance is the development team's previous experience with HUD mortgage insurance programs for new construction.
  2. Maps and photographs illustrating the location, boundaries, conditions and features of the site, noting in particular the location and size of public utilities lines available to serve the site, means of access and egress, and proximate properties.
  3. The borrower's summary design program or concept prepared after inspection of the site and preliminary review of existing or proposed zoning, subdivision, and building code requirements. The summary should characterize the contemplated number, size, and kind of buildings and dwelling units and should include a conceptual site plan and sketch plans of typical units and buildings. In particular the summary design program should identify key issues presented by the site and its environs, such as, but not limited to:
    - a. Terrain, rock or steep slopes that may require detailed exploration, unusual site costs or result in any claim of site impracticality exemption from the design and construction accessibility requirements of the Fair Housing Act;
    - b. Absence or unavailability of public utilities requiring off site work, unusual public permitting or development entitlement processes or costs;
    - c. Insufficient or deficient access and egress due to limitations on existing streets and grades or lack thereof and/ or adverse traffic patterns or conditions.
  4. The lender should describe existing or ongoing needs for site due diligence and provide a plan or description of how due diligence tasks will be completed, including appropriate sequencing, coordination of studies, and the identity of prospective providers.
  5. The lender should identify any other contemplated sources of funding that would trigger design and/or construction requirements and describe such requirements (e.g., any Federal assistance, such as HOME, will trigger Section 504 and UFAS; state or local assistance, including LIHTCs, may trigger a state or local agency plan for compliance with Title II of the Americans with Disabilities Act).

6. The lender should state whether streamlined processing of design and construction documents is proposed and the reasons such processing is both needed (e.g. use of LIHTCs is expected) and realistic (e.g. development team is experienced with HUD insured mortgage programs for construction, has successfully executed physically similar projects, and the site and/or environs present no complex challenges or prospective delays.).
- B. Pre-Application. The lender's underwriter must have visited and inspected the site, and the lender must submit the following Pre-application exhibits to HUD:
1. Form HUD-92013, Application for Project Mortgage Insurance.
  2. Location map with property clearly defined.
  3. Sketch plan of the site showing overall dimensions of main building(s), major site elements, (e.g. parking lots, points of access and egress, pedestrian access, and accessible entrances and paths.) and location of existing utilities, (e.g. water, sewer, electric, gas) in the streets adjacent to the site. Contour lines and elevations are not required in the sketch site plan. However, the lender must state whether any contours or elevations observed are likely to result in a claim of exemption of any proposed building or facility from the design and construction requirements for accessibility of the Fair Housing Act by reason of site impracticality. (See Fair Housing Design Manual 1.38). If so, the lender must confirm that it has advised the borrower, the design professional(s) and the general contractor of the site feasibility methodology described in the Fair Housing Act Design Manual. Similarly, the lender must describe whether and how any design and construction requirements triggered by other sources of funding will be met.
  4. Sketch plans of building(s) that show:
    - a. Typical floor plans showing apartment types, placement and dimensions;
    - b. Ground floor plans showing common areas and dimensions;
    - c. Sketch floor plans of typical dwelling units;
    - d. Sketch elevations of typical buildings;
    - e. Residential and gross building area for each building or building type;
    - f. Typical wall sections showing footing, foundation, and wall and floor structure, with notes indicating the basic materials to be used in the structure, floor and exterior finishes; and
    - g. Anticipated interior finish schedule indicating kind and quality of finishes proposed for units, including kitchens and baths, as well as building common spaces and accessory structures.
  5. The lender must address any physical due diligence issues identified and ongoing due diligence needed to complete analysis of the site and its environs. If not addressed at a concept meeting, the lender should provide a description of the studies completed or anticipated and the identity of those preparing the studies. Completed or proposed due diligence should include investigation of the physical requirements that may be imposed by any other sources of funding anticipated for the project.

- C. Firm Commitment Application. The lender's construction analyst must have visited and inspected the site and its environs, investing time and attention to detail sufficient to allow the analyst to appreciate due diligence needs and to knowledgeably evaluate prepared due diligence and all design and construction documents. The lender must submit the following exhibits for review, provided that, if the application is approved for streamlined processing, the following exhibits may be submitted as substantially completed drafts and resubmitted as proposed final drafts at least 30 days prior to initial endorsement (See 5.6 above):
1. Form HUD-92013, Application for Project Mortgage Insurance.
  2. Owner-Architect Agreement, AIA Document B108 (and HUD Amendment to the B108), fully defining the services and fees for each prime design professional with which the borrower/owner contracts directly. Additional contracts must be submitted for any part of the basic design services with more than one prime professional, e.g. for site, civil, mechanical, electrical engineering services, etc., or supervisory architectural services. The project architect shall have the authority and duty to coordinate multiple prime professional contracts.
  3. Completed Surveyor's Report, Form HUD-91073M, with responses to all questions and the completed HUD certification. See Appendix 5A.
  4. Engineering and specialty reports, e.g. geotechnical, termite control, structural, etc.
  5. Municipal and utility company letters of confirmation for the provision of services and/or offsite improvements.
  6. Any documents necessary to establish:
    - a. Site ingress and egress, utilities service and other general acceptability criteria in MPS 4910.1, Chapter 2.
    - b. Binding or signature ready drafts of proposed joint use, access and maintenance agreements where common use easements (e.g., common driveways) exist or are proposed. When proposed, easements should be platted and agreements drafted for review in preparation for recording.
  7. Certification from project architect substantially in the form of Appendix 5H.1.
  8. Contract drawings and specifications that conform to the specific format and requirements described in Appendix 5E.
  9. Offsite Construction: Description of all work essential to the project but outside the boundaries of the property (see Appendix 5E).
  10. The general contractor's Cost Breakdown, form HUD 2328.
  11. The lender's CNA based on construction plans and specifications of the improvements to be built. Of the following portions of the CNA, the first, ("a"), should be completed by the Project Architect. The remaining three ("b", "c", and "d") may be completed by the lender's construction analyst. The CNA must be completed and submitted using the CNA e Tool in accordance with Appendix 5G and includes:
    - a. A HUD Custom Statement of Energy Design Intent (SEDI) from EPA's Portfolio Manager based on projected utility consumption for each building to be built. The projection should assume that the building is constructed in accordance with the plans and specifications. This

projection must be prepared by the project architect or another licensed or certified professional retained for this purpose and should utilize recognized building energy simulation methods and tools, e.g., RESNET Home Energy Rating System for low rise construction. Professional certifications for building energy simulation include the American Society of Heating, Refrigerating and Air-conditioning Engineers (ASHRAE) Building Energy Modeling Professional designation and the American Energy Engineers (AEE) Certified Building Energy Simulation Analyst. The projected whole building utility consumption data resulting from energy modeling should be reported to Portfolio Manager and the HUD Custom SEDI obtained. The resulting HUD Custom SEDI must show an energy score not less than the prescribed minimum. (See Appendix 5G.) Note that the HUD Custom SEDI minimum score is a requirement in addition to and not in lieu of the obligation to prepare plans and specifications meeting the requirements of the applicable version of the International Energy Conservation Code or the ASHRAE standard 90.1. (See Appendix 5D for minimum energy code requirements.).

- b. A completed physical inventory of the property to be built, (that is, description of site, buildings, units, utility types and rates, components and alternatives in the CNA e Tool).
- c. An estimate of replacement cost, as new, for each structure (form HUD 92329, Schedule of Insurable Values) which cost should in the aggregate be consistent with the lender's construction analyst's estimate of costs for structures including general requirements, contractor's overhead and profit.
- d. The lender's financial plan for funding future capital replacement needs based on actual expected replacements with appropriate adjustments for inflation and other variables as described in Appendix 5G. The financial plan will define the schedule of annual deposits to the Reserve for Replacement escrow.

12. The lender's construction analyst's detailed cost estimate package composed of the following:

- a. Detailed cost estimate to be reported on Form HUD-92326.
- b. A comparison of the general contractor's trade line item cost estimate (HUD 2328) with the lender's construction analyst's estimate (HUD-92326) with comments and explanations described on form HUD 92331.
- c. The lender's construction analyst must sign and date the HUD-2328 in the FHA: Processing Analyst box. The lender's underwriter must sign and date the HUD-2328 in the FHA: Chief Cost Branch or Cost Analyst box.

13. The lender's construction analyst's completed architectural and cost sections of the form HUD 92264. The analyst must sign and date the form as both "Cost Processor" and "Architectural Processor." If different analysts execute the architectural and the cost reviews then each must sign as appropriate.

14. The lender's construction analyst's review and disclosure of identities of interest and application of the 50%-75% Rule (See Chapter 13, sections 13.16 M and 13.17 for instructions on this Rule.):
  - a. Identify and describe any identity of interest relationships between or among the Borrower, any of the Borrower's design professionals, the general contractor, any subcontractors, material suppliers, equipment lessors, or manufacturers of industrialized housing.
  - b. Identify by analysis of the HUD 2328 any single subcontractor that executes 50% or more of the total construction or any three subcontractors who in the aggregate execute 75% or more of the total construction measured by dollar value.
15. The proposed but unsigned owner contractor agreement for construction (HUD 92442M) indicating any selected options (e.g. incentive payments, etc.) or special conditions, the Supplementary Conditions (HUD 92554M).
16. Review report prepared by lender's construction analyst who must state that all exhibits are acceptable without conditions, and that all deficiencies have been acceptably corrected, except that in the case of an application approved for streamlined processing, this statement may allow for the contingency that final plans and specifications have not been completed and that final cost estimates may vary by up to 5% from the costs estimated in the Firm Commitment application. The report should address the following:
  - a. Completeness of construction documents;
  - b. Conformance to local building codes and HUD standards, including the HUD minimum energy codes when these exceed local code requirements;
  - c. Accessibility for persons with disabilities. Refer to the Fair Housing Act design and construction requirements for accessibility found at 24 CFR 100.205. If the property is federally assisted, refer also to the Uniform Federal Accessibility Standard. For any public space at the property (e.g. leasing office, commercial space), refer to Title III of the Americans with Disabilities Act (See Appendix 5B).
  - d. Site design:
    - 1) Placement of buildings, roads, walks and parking on the site;
    - 2) Identification and review of offsite construction;
    - 3) Site erosion and storm drainage; and
    - 4) Soil borings report.
  - e. Building design:
    - 1) Building circulation:
      - (a) Adequacy of elevators;
      - (b) Number and placement of stairs;
      - (c) Adequacy of lobbies and corridors; and
      - (d) Adequacy of fire egress.
    - 2) Typical dwelling units: Adequacy of room sizes and circulation within units.

- 3) Fire safety: Provision of adequate fire safety measures, e.g. fire sprinklers, firewalls, fire doors (if required).
  - 4) Structural adequacy: Review of building structure and structural details including measures implemented to address identified hazards such as seismic risk, coastal high wind and/or flood zones.
  - 5) Mechanical, electrical and plumbing adequacy: Review of mechanical and electrical and plumbing plans.
  - 6) Energy efficiency. Review utility combination for energy efficiency and determine acceptability of utility combination. Review and submit the Capital Needs Assessment in the CNA e Tool per Appendix 5G and confirm that the HUD Custom SEDI shows an energy score of 60 or better. See Appendix 5D for applicable International Energy Conservation Code and ASHRAE standards for new construction.
- f. Submit copies of the lender's construction analyst's project files and logs only if requested by the HUD Office.
- g. Standard certification by lender's construction analyst(s) (see Chapter 11 Section 11.2).

## **5.8 Firm Commitment through Initial Endorsement – New Construction**

- A. Except for projects submitted as streamlined applications, drawings and specifications may be amended by addendum when the change(s) will have no effect on cost or value. (Final drawings and specifications are perfected after Firm Commitment in streamline processing.) The lender's construction analyst must review the addenda for acceptability as follows:
- 1) Addenda must clearly state or show the change with specific reference to the location of the item on the drawings or in the specifications.
  - 2) Amendments shall be clearly noted and dated.
  - 3) Addenda are not to be used to correct errors noted during Firm Commitment processing.
- B. Firm commitment reprocessing is required for major changes adding or deleting work representing a net change of more than 5% of estimated total construction costs, or physical changes that alter underwritten income and expense so as to reduce the approved mortgage amount by a sum greater than 5% of total construction cost. Drawings and specifications affected must have sheets and pages revised and replaced.
- C. Construction Documents. The lender shall submit the following construction documents to HUD for review and approval prior to initial endorsement:

1. Final, signature-ready drafts of the Building Loan Agreement, Form HUD-92441M, the Construction Contract, Form HUD-92442M and the Supplementary Conditions to the construction contract (HUD 92554M).
  - a. Assure the correct identification of drawings and specifications on contract forms.
    - 1) Project name, HUD project number, and project architect's name.
    - 2) Drawings and specifications by sheets, pages and date or by index with date of last revision of sheet and page.
    - 3) Addenda, if any, by number and date.
  - b. Assure compliance with any architectural requirement or condition.
2. Survey and Surveyor's Report, Form HUD-91073M, which must be reviewed:
  - a. For compliance with Survey Instructions and Certificate.
  - b. To confirm that the legal description and survey property boundaries agree.
  - c. To confirm consistency of the approved plans and site plan with the survey and the description of any easements, joint use and access agreements, dedications of land for public rights of way, and state or local subdivision requirements.
3. Contractor's Estimated Progress Schedule. Article 3.10.1 of the AIA General Conditions requires the general contractor to prepare and submit an "estimated progress schedule for the work" to the borrower and project architect. (See instructions for how to prepare the progress schedule in this Chapter at 5.11.D.5)
  - a. The borrower or project architect must submit a copy to the lender's construction analyst at least 30 days before initial endorsement, and a final copy must be provided with the permit-ready drawings not later than 10 days prior to endorsement.
  - b. The lender's construction analyst must review the schedule to ensure it relates to all the construction activities required by the construction documents, including dates for the stages of construction.

Copies of the approved schedule are distributed with other construction documents at initial endorsement and used to monitor construction progress.
4. Drawings and Specifications. Submit three sets and confirm that:
  - a. Master Sets No. 1, 2 and 3 are the same as accepted and identified in the Firm Commitment. (For projects approved for streamlined processing, the lender must confirm that the final plans and specifications are acceptable, complete and consistent with Firm Commitment exhibits.) Indicate the total number of pages in the drawings and specifications. HUD may, at its discretion, eliminate the requirement for set No. 2 (HUD review set).
  - b. Cover and last drawing sheets, and the first and last specification pages of all sets, are signed by representatives of the project architect, architect administering the contract, owner, contractor, lender and bonding company, if any.
  - c. Master Set is bound and signed as described above on the cover sheet and last sheet of the drawings and the first and last pages of the specifications. Signatories must initial opposite any

“last minute” revisions not covered by Firm Commitment or addendum. The master set must be identified as such.

- d. Lender’s signatory is an individual or individuals who are authorized to sign at closing, and who must sign and initial the plans and specifications (see Appendix 5E). HUD will only accept the lender’s authorized signatory, who must be identified as such for HUD by the lender.

5. Drawings and Specifications. Lender must retain one set and confirm that the:

- a. Lender set is the same as the set that was accepted and identified in the Firm Commitment (or approved after Firm Commitment per streamline processing). Indicate the total number of pages in the drawings and specifications.
- b. Cover sheets are signed by representatives of the project architect, architect administering contract, owner, contractor, lender, and bonding company, if any.
- c. Lender set is signed by signatories on the cover sheet and the last sheet of the drawings and the first and last pages of the specifications. Signatories must initial opposite any “last minute” minor revisions not covered by Firm Commitment or addendum or as approved per streamline processing.

D. If construction documents are correct, the HUD senior underwriter will recommend initial endorsement. In the event of errors or inconsistencies, the construction documents will be returned to the lender for correction and resubmission.

E. Distribution of Drawings and Specifications.

1. After initial endorsement, HUD will distribute the drawings and specifications as follows:

- a. Set No. 1, Master Set, is the legal contract document. HUD will:
  - 1) Retain this set until the last guarantee inspection.
    - (a) Add a copy of each change order, form HUD-92437.
    - (b) Add a copy of each architect’s supplemental instruction.
  - 2) Package the specifications in a tightly rolled bundle with drawings on the outside, attach a memo indicating the HUD project number, and send it to the Regional Federal Records Center one year after completion of construction.
- b. Set No. 2 is the HUD Office’s review set.
  - 1) HUD staff will use this set for processing change orders, review of inspections and similar functions.
  - 2) Dispose of this set after final endorsement.
- c. Set No. 3 is the HUD office’s job site set.
  - 1) The HUD inspector will use this set for inspection of the project.
  - 2) The HUD inspector will conform this set to the contractor’s “record set.” (The Contractor is required to maintain at the site a record set for the Owner.)

- 3) The HUD inspector will return this set to the HUD office upon completion of construction. This set is the HUD “as-built” set.
- 4) Use this set for guarantee inspections.
- 5) Send the “as-built” set to the HUD Regional Center/Satellite Office Director, one year after completion of construction, for use in loan servicing.

2. Drawings and specifications to be maintained by the lender (the lender set):

a. The lender must maintain this set for a period of three years after final endorsement.

- 1) Add a copy of each change order, form HUD-92437.
- 2) Add a copy of each architect’s supplemental instruction(s).

b. If the originating lender will not administer the construction contract, the construction administering lender must forward copies of each change order and architect’s supplemental instruction to the originating lender for inclusion in the lender set.

F. Early Start of Construction. Construction may not start before initial endorsement and recordation of the insured mortgage, except with the prior approval of the Director of the MF Regional Center/Satellite Office. Generally, work performed after receipt by HUD of the initial application but before initial endorsement constitutes an early start of construction. Some work such as clearing, grading, minor demolition, environmental remediation or other minor preliminary work may or may not constitute an early start of construction; (e.g. site improvements or grading on a separate, adjacent site might result in necessary adjustments to surface drainage or grades on a subject site and might be permissible; or utilities serving multiple proximate parcels might require installation of a main across a subject site, and such work might be permissible.) HUD staff must confirm this work during the review stage of the application and the MF Regional Center/Satellite Office Director may approve. No work shall proceed without the borrower obtaining and evidencing all state or local approvals or permits requisite for that work.

The following are mandatory conditions for approval of an early start of construction:

1. Firm Commitment. There must be a valid outstanding Firm Commitment, including:

- a. Site control, and the right to legally access the site for purposes of construction.
- b. HUD-approved set of contract drawings and specifications on file. See Appendix 5E for required Firm Commitment contract drawings and specifications.
- c. Required construction contract and other construction documents, including, but not limited to:
  - 1) Construction contract, form HUD-92442M;
  - 2) Supplementary conditions of the contract for construction, form HUD-92554M;

- 3) applicable Davis-Bacon wage decision (supplied by HUD Labor Standards and Enforcement);
2. Assurance of Completion for On-Site and Off-Site Work. The early start may not hamper the ability of the borrower to obtain a title policy when the loan goes to initial closing.
3. Valid Basis for Early Start. The MF Regional Center/Satellite Office Director must document the file including the reason for granting an early start, after determining that:
  - a. An immediate closing is not practical.
  - b. There is reasonable evidence and assurance that closing will occur in the near future.
  - c. There is a compelling need to start construction before the anticipated closing date.
  - d. An early start of construction will not be detrimental to HUD's interests.
  - e. HUD has no insurance obligation or liability whatsoever for costs incurred during an early start if the project does not reach initial endorsement.
4. The contractor, borrower and lender must execute Form HUD-92415, Request for Permission to Commence Construction Prior to Initial Endorsement for Mortgage Insurance, without change. The MF Regional Center/Satellite Office Director must sign form HUD-92415.
5. Preconstruction conference must be held before the start of any construction (see Chapter 12 Section 12.2).
6. Violations of early start criteria must be referred to the MF Regional Center/Satellite Office Director for a determination as to whether the project may proceed to initial endorsement.

## 5.9 Substantial Rehabilitation, Standard Processing- Concept Meeting through Initial Endorsement

All of the previous instructions for standard processing of applications for new construction (Sections 5.7 and 5.8 of this Chapter) apply to substantial rehabilitation projects except as modified here.

- A. **Concept Meeting.** The concept meeting is an important opportunity to describe and determine the expected scope of work for existing properties, which may range from gut rehabilitation to more limited repairs and alterations that meet the thresholds for substantial rehabilitation as described in this Chapter 5.1.D. Existing properties with a lesser scope of construction activity should be processed under Section 223(f).
  1. The class of work will determine whether a CNA is used to define the scope of work or merely to describe the as-built result of a scope of work elsewhere defined. (See Appendix 5G, Section III.A.2.) A key result of the concept meeting should be consensus on the methods and the identity/qualifications of professionals that will be used to evaluate the existing buildings and define the scope of work. Note also that methods for verifying utility consumption will differ depending on the class of work. (See Appendix 5G, Section IV.A.) For gut rehabilitation, the

CNA and utility consumption verification will be prospective and based on design plans and specifications similar to CNAs prepared for new construction. But for lesser scopes of work, these items will be retrospective based on existing conditions and will be used to inform the preparation of the scope of work. In the latter instance, when the energy score reported for the property is less than the prescribed minimum, the CNA must include an ASHRAE Level II Energy Audit. The lender and project architect must describe a process consistent with Appendix 5G and a timeline for evaluating the existing buildings and developing the scope of work and supporting due diligence.

2. **Seismic Threshold for Retro-Fit Analyses.** Appendix 5C defines a step by step process for determining whether seismic conditions warrant further analyses of existing buildings in accordance with the most recent standards of the American Society of Civil Engineers (ASCE). The threshold is easily determined, requires no on-site analysis or observation of buildings or sites and should be provided at the concept meeting to indicate whether seismic analyses are required. (The CNA e Tool requires a determination of these same threshold values.)
3. **Other Due Diligence Studies or Reports.** The lender should describe the existing or expected due diligence analyses including lead based paint inspection for buildings constructed prior to January 1, 1978, buildings with asbestos materials and any other known or reasonably anticipated hazards. (See Chapter 9)

**B. Pre-application.** The lender's exhibits for pre-application are the same as those for new construction with these additional items or considerations:

1. **Due Diligence and Design Work Plan.**

The lender should prepare and submit a concise but definitive work plan for the preparation of detailed plans, specifications and cost estimates including whether existing conditions will be evaluated by means of the CNA under the supervision of the project architect or by the project architect's detailed inspection of the property.

- a. **Substantial Rehabilitation Less than Gut Rehab.**

A CNA must be used to evaluate existing structures when the scope of work is less than gut rehabilitation. In such cases, the list of immediate repairs generated by the CNA e Tool is the project architect's detailed work write-up. This may be prepared in the CNA e Tool by the project architect, by a needs assessor retained by the project architect, or by the lender's needs assessor/construction analyst. (However, a needs assessor retained by the project architect may not act as the lender's construction analyst in the same transaction.)

- b. **Intended Refinances Found to be Substantial Rehabilitation.**

In cases where an intended refinance application is found to be substantial rehabilitation by reason of the required scope of work discovered through a CNA, the project architect should review the CNA and should also conduct a detailed inspection, after which the CNA must be updated as required to reflect any modified or additional repairs and alterations prescribed by the project architect. In this event the lender's needs assessor may also act as the lender's construction analyst and may update the initial CNA to reflect the project architect's modified or additional repairs.

c. Gut Rehabilitation.

When gut rehabilitation is contemplated, the CNA should be completed after the preparation of, and based upon, plans and specifications as if for new construction (See this Chapter 5.7, subsection C, paragraph 12 and Appendix 5G). The work plan should identify the due diligence professionals to be engaged and describe their qualifications. The composition of the due diligence team should address the issues foreseeable based on the borrower's objectives and the project architect's and the lender's observations during a preliminary inspection of the property. The results of any more advanced due diligence agreed upon at the concept meeting (e.g., a joint inspection by the design team) should inform the pre-application.

2. Joint Inspection.

Past practice has relied upon joint inspections by HUD staff and the project design team to assess existing conditions. This was necessary in part because CNAs were not prepared for or used in most substantial rehabilitation applications. Such assessments are now integrated into the process for defining the scope of work for rehabilitation. Accordingly, the purpose of the joint inspection is as follows:

- a. To ensure that HUD staff, the lender's underwriter and construction analyst, and the project architect, engineer and general contractor have a common understanding of physical conditions at the site. It is useful for the local Building Code Official or his or her representative to be present, particularly in the case of older properties characterized by building methods or technologies no longer commonly used in construction or with buildings that lack life safety and fire suppression measures or adequate means of emergency ingress/egress. Often a HUD representative will not be able to attend, in which case the lender should provide annotated photography and notes of conditions observed. Such information may also be communicated with attachments in the CNA e Tool if the CNA has already been prepared.
- b. To ensure that all due diligence inquiry and physical investigation needs have or will be identified and addressed, and/or to assist in achieving consensus (or confirming an existing consensus) on methods and procedures to be used to evaluate conditions and prepare the rehabilitation scope of work.
- c. The joint inspection should be arranged by the lender, attended by the lender or the lender's representative, and documented by the lender with minutes and conclusions distributed in writing to all participants.
- d. The joint inspection should be scheduled as early as feasible and may follow the concept meeting. If not scheduled prior to the pre-application, it must be scheduled promptly following the pre-application and before the execution of further due diligence or design work.
- e. Except for LIHTC projects, a decision on any request for streamlined processing should be made only after the joint inspection, or subject to the completion of the joint inspection.

3. Substantial Rehab and Requests for Streamlined Processing.

Given the more contingent and variable circumstances typical of work with existing buildings (by contrast with new construction), any borrower or lender request for streamlined processing for substantial rehabilitation (other than LIHTC projects) must include documentation demonstrating prior experience and capacity in properties of similar scale, condition and building technologies

employed. This demonstration should be made for each participant: sponsor, project architect and design consultants, needs assessor and any due diligence consultants, general contractor and the lender's construction analyst.

4. Sketch plans of the existing building(s) "as-is" should be provided with the pre-application.
  5. The lender should determine the year built for each building and whether each building was built for first occupancy after March 13, 1991 using dates of occupancy permits and building permits when any doubt exists. (If a CNA is prepared, the CNA e Tool will require the needs assessor to obtain and supply this information.) If first occupied after March 13, 1991, each such building must conform to the design and construction requirements of the Fair Housing Act (42 USC 3604(f)(3)(C), and 24 CFR 100.205). See Appendix 5B.
  6. The lender must determine whether the property is proposed to be or ever has been Federally assisted. (The CNA e Tool requires this information.) If so, the property must conform to the Uniform Federal Accessibility Standards and the requirements of 24 CFR 8.23, 8.26, 8.31, and 8.32. See Appendix 5B.
  7. Preliminary Work Write-up: The lender should describe or provide the project architect's description of the proposed rehabilitation (from preliminary inspection of the property conducted by the project architect), including post-rehabilitation sketch plans. The preliminary work write-up may precede the project architect's detailed inspection and the detailed work write-up and/or the CNA. If a CNA has already been prepared, the list of immediate repairs generated by the CNA e Tool can be the preliminary work write up.
  8. The lender should provide lead based paint (LBP) test reports for projects constructed prior to January 1, 1978, and asbestos report (see LBP and asbestos standards in Chapter 9). Delivery of these due diligence items may be deferred until Firm Commitment if consistent with and scheduled as part of an agreed work plan for due diligence.
- C. **Firm Commitment Application.** The lender shall submit final plans, drawings, specifications and costs analyses and unsigned contract agreements similar to applications for new construction except as follows:

1. Form of Drawings and Specifications Matched to Scope of Work.

The borrower's architectural/engineering and cost exhibits for substantial rehabilitation must be based on due diligence studies and examination of existing conditions. Because existing conditions vary widely, the extent and form of drawings and specifications will also vary. When a CNA is used to develop the scope of work, and only limited drawings are required to describe reconfiguration of selected spaces, or shop drawings are used detailing selected items (e.g. window and door replacement/installation or new or closed openings, kitchen or bath plans or similar Level 2 Alterations), these drawings should be attached to the CNA when it is submitted; and the component alternatives form of the Assessment tool should be used to provide detailed specifications. Alternatively, detailed specifications may be prepared separately, keyed to alternative components selected in the CNA e Tool, and this specification document attached to the CNA at submission. Documents prepared in the CNA e Tool or attached to the CNA may be printed in the requisite sets and copies for signature and distribution at initial endorsement.

For gut rehabilitation, plans and specifications should be prepared and submitted in the same manner as for new construction.

2. Lender Construction Analyst's Review Report.

When less than full construction drawings and specifications are prepared, the construction analyst should specifically determine whether the scope of work is described adequately with a level of detail which describes measurable quantities, specified quality or performance standards, precise locations of work and is both actionable and amenable to inspection of completed work. The review report should confirm that the documents address the existing conditions.

3. Building and Unit Areas and Counts.

Building and unit area and unit count breakdowns for structures as well as project totals will be recorded in the CNA and a summary table may be printed for use with other design documents attached to the CNA for substantial rehabilitation projects less than gut rehabilitation. For gut rehabilitation, the schedule (table) of buildings and units should appear in the drawings prepared by the project architect in accordance with Appendix 5E; these counts and areas should be entered in the CNA when it is prepared pursuant to the drawings and specifications prepared for gut rehabilitation. An approved CNA prepared in the CNA e Tool creates a permanent record of this information.

4. Operation and Maintenance Plans.

For projects that contain lead based paint (LBP), asbestos, or have ongoing risks such as radon that may require permanent installation of ventilation, detection or alarm devices, the borrower or project architect is responsible for engaging the services of qualified abatement contractor(s) to prepare a scope of work for the abatement or mitigation. Where the scope of abatement work consists of permanent enclosure or encapsulation or ongoing monitoring, but not removal, a qualified consultant or abatement contractor(s) must also prepare, separate from the scope of abatement work, an Operations and Maintenance (O&M) Plan. The O&M Plan must describe ongoing maintenance procedures to be followed for as long as the hazard remains in place. All abatement work and ongoing maintenance activities for radon, LBP, asbestos, and/or any other hazards shall conform to the requirements described in Chapter 9. At the time the CNA is submitted in the CNA e Tool, any O&M plans should be attached with the submission.

A condition shall be attached to the Firm Commitment requiring that the borrower operate and maintain the property consistent with the referenced O&M plan(s) for the duration of the insured mortgage.

5. Submission of Due Diligence Reports.

When the CNA e Tool is used to prepare and document the scope of work, due diligence, engineering, energy audit and related studies, and reports which otherwise might be submitted as part of a paper application package, should be attached to the CNA when it is submitted.

6. Davis-Bacon Wage Standards and the CNA e Tool.

When the CNA is used to develop the scope of work, costs of repairs are itemized in the CNA e Tool. However, Davis-Bacon wage decisions are not used in these estimates, as this could distort estimates of future replacement costs which are not subject to wage decisions. Accordingly, the summation of costs in the standard trade breakdown and general contractors estimate (HUD 2328) should estimate and restate the cost of proposed repairs and alterations based on the contractor's use of the prevailing wage decision. The lender's construction analyst's detailed estimate (HUD-92326) and comparison of estimates (HUD-92331), together with the architectural and cost portions of the HUD 92264 signed by the construction analyst, should also reflect use of the prevailing wage decision. When completed, these HUD forms should be attached to the CNA for

submission by the lender. Note also that the two estimates of costs are formatted differently: the CNA e Tool organizes costs by component, which may be sorted by ASTM category as reflected in the Standard Table of Estimated Useful Life. This provides a form of trade based categorization but is not the same as the HUD 2328 and related forms which report costs by CSI's trade-based categories.

7. Project Architect's Certification.

For applications proposing substantial rehabilitation and not gut rehabilitation, the project architect's certification (Appendix 5H.1) should be attached to the CNA at the time it is submitted (or resubmitted) in the CNA e Tool.

8. For gut rehabilitation when the CNA is prepared based on plans and specifications to be built (as for new construction), the construction documents, project architect's certification, due diligence, engineering and related studies, if any, and the lender construction analyst's cost package are submitted in the same manner as for new construction.

9. When the property will be rehabilitated, consultation with the State Historic Preservation Officer (SHPO) is required as part of HUD's determination of whether the property is a historic property or is in a designated historic district, and whether there will be adverse effects to a historic property. The SHPO consultation must be completed no later than the submission of an application for Firm Commitment. (See Chapter 9).

D. Firm Commitment to Initial Endorsement.

After Firm Commitment and not later than 30 days prior to initial endorsement, the lender must assemble the final, printed plans, drawings, specifications, construction schedule, and contract forms. Even if such documents were submitted as attachments to the CNA e Tool, or otherwise electronically submitted, they must still be printed, and signed in the requisite number of counterparts as described in Section 5.8 and confirmed as sufficient, authentic and final documents for contract purposes.

## **5.10 Processing for Refinance or Acquisition, Section 223(f) and 223(a)(7) and 241(a) for Repairs and Alterations**

The previous instructions in this chapter apply to projects insured pursuant to Section 223(f) and 223(a)(7) and Section 241(a) supplemental loans for repairs and alterations, except as modified below.

A. Architectural Standards. Eligible properties are existing buildings, and the criteria for acceptance are not the same as for proposed construction. See Appendix 5 for architectural standards for existing buildings.

B. Limitation on Repairs for 223(a)(7). The intent of the 223(a)(7) program is to provide a simple, quick refinance option for existing insured properties to improve cash flow by lowering the interest rate or extending the amortization period, reduce the risks of default and improve overall financial performance. Accordingly, repairs that reconfigure space are not permitted except for limited dimensional changes as remedies for accessibility deficiencies. In terms of the classification of work, activity is limited to repairs and Level 1 Alterations (excepting accessibility deficiency items as noted.) Moreover, no environmental review is intended for 223(a)(7) applications, and so repairs and alterations are further limited to those considered to be routine maintenance. (See Chapter 9.1

Subsection A, paragraph 5.) The total cost of repairs and alterations (excluding the costs of remedies for life safety or accessibility deficiencies) may not exceed \$1,500 per unit.

- C. Neither concept meetings nor pre-applications are needed for 223(a)(7) applications and are not required for 223(f) applications, so Firm Commitment applications may be submitted directly to HUD for review. A concept meeting may be advisable for 223(f) applications where expected Repairs, Level 1 and Level 2 Alterations (or Level 3 Alterations in some buildings) are significant and may approach or exceed the threshold definition of substantial rehabilitation (See 5.1.D). In that event, the purpose of the concept meeting is to determine the scope of work, or to establish agreed upon due diligence that will determine the scope of work.
- D. A CNA based on existing conditions is required for all applications. The lender must retain a qualified needs assessor who must complete the assessment in accordance with Appendix 5G not earlier than 180 days prior to the application for Firm Commitment, provided that in the case of 223(a)(7) applications a CNA may be accepted if:
  - 1. It is dated not more than 2 years prior to the date of application for Firm Commitment;
  - 2. The MF Regional Center/Satellite Office Director approves the use of the existing CNA for purposes of the application;
  - 3. The CNA contents and scope conform to the requirements of Mortgagee Letter 2012-25 in lieu of Appendix 5G and use of the CNA e Tool for its preparation and submission; and
  - 4. The mortgagor and lender are required to provide a new CNA not later than 10 years after the date of the CNA accepted with the application.
- E. Stale Needs Assessments. In the event that the lender fails to submit an acceptable application for Firm Commitment within 180 days from the date of the CNA, HUD will return the CNA to the lender and the lender must order an updated CNA. The needs assessor must re-inspect the subject property, updating any structure and/or site conditions observed, and submit the new CNA in the CNA e Tool.
- F. By submission of the CNA through the CNA e Tool, the lender certifies that it has selected a qualified needs assessor with no conflicts of interest in the transaction and has reviewed the assessment for completeness, accuracy, reasonableness and conformance to HUD requirements. (See Appendix 5G for certification language.)
- G. Other required architectural/engineering/cost exhibits which the lender must attach to the CNA at submission are:
  - 1. A completed A/E portion of Form HUD-92264.
  - 2. Certificate of Occupancy or Final Inspection Report, if available, or a statement from the jurisdiction with building and/or zoning code enforcement authority recognizing any legal non-conforming use.
  - 3. Municipal Code Violation Report/Clear Report, and Fire Marshall's Report/Clear report.
  - 4. City/County Health Officer's report/clear report where private water supply or sewage treatment systems are involved.
  - 5. Location map.
  - 6. Aerial photograph or satellite view of site.
  - 7. Set of as built plans, if available, which, if not already digital, should be converted to digital files

and saved as Portable Document Format (pdf) files.

8. Annotated photography and other physical due diligence reports as needed based on observed conditions, in accordance with Appendix 5G
  9. Any O&M plans in use or proposed for use at the property.
  10. If a project architect has been retained, attach the following:
    - a. The owner architect agreement, AIA B104;
    - b. The project architect's certification for a refinancing transaction substantially in the form of Appendix 5H.2; and
    - c. Any drawings or sketches describing reconfigured spaces and/or altered site improvements with each clearly labeled to identify the building(s), unit(s), space(s) or improvements where the reconfigured space or altered site improvements are proposed.
  11. If a general contractor has been retained, the lender must ensure that the needs assessor/construction analyst has reviewed the general contractor's cost estimate in light of the estimated cost of immediate repairs forecasted by the CNA and that the two estimates are reconciled and brought into agreement. The lender should attach the following when submitting the CNA:
    - a. The owner-contractor agreement, AIA A107;
    - b. The contractor's cost breakdown, HUD form 2328; and
    - c. The contractor's schedule for the proposed work, which should be reflected in the CNA by entering a number of months in the "Time to Complete" cell of the "Repair Replace Recommendation" form of the CNA e Tool assessment file. (See Appendix 5G, Section V)
- H. Form HUD 92013 must be completed and submitted with the application for Firm Commitment.
- I. An ALTA/ASCM Land Title Survey, and Form HUD-91073M, Surveyor's Report; and Title Report. For specific survey requirements, see Appendix 5A, Subsection G.
- J. Maximum Time for Completion of Repairs. Appendix 5G and the CNA e Tool require that all repairs and alterations be identified as either critical or non-critical. Critical repairs are identified as either Life Safety or Accessibility. Those identified as "Life Safety" are needed to address hazards to life and health while those identified as "Accessibility" are needed to correct accessibility deficiencies. While these are not mutually exclusive, only one designation may be applied to each repair or alteration. All other repairs and alterations are non-critical repairs.

Life Safety repairs must be completed prior to Endorsement.

Accessibility repairs must be completed as soon as possible; and the CNA e Tool requires that the time estimated to complete each accessibility repair be identified as a number of months. If "as soon as" possible exceeds twelve months for any Accessibility repair, the corrective action plan must be referred to HUD headquarters to the attention of the Director of Technical Support in the Office of Multifamily Housing Production, who will determine whether the proposed corrective action plan is acceptable.

Non-critical repairs must be promptly and timely executed and completed within twelve months of endorsement, provided that the MF Regional Center/Satellite Office Director may approve an extended period not to exceed six additional months for unusual circumstances (e.g. work constrained

by weather conditions or work requiring temporary relocation of elderly or disabled tenants.). A program of repairs and alterations which because of scale or quantity is reasonably expected to require more than a year to complete should be reconsidered as substantial rehabilitation.

- K. If proposed repairs or alterations require occupancy or cash flow disruption, the lender should estimate such losses by month and add the aggregate total to an operating deficit escrow, not the repair escrow.
- L. Funding Repairs, Escrow Agreement for Deferred Repairs (Form HUD-92476.1M) See this Form, Chapter 8 Section 8.11.A.2.c and Chapter 12 Section 12.17.A for greater detail on these provisions.
  - 1. The costs of the deferred repairs (including materials, labor, permits, profits, etc., trended to the start of repairs) must be estimated and withheld *in cash* from mortgage proceeds and placed in escrow. In this context, deferred repairs includes all immediate repairs identified in the CNA that are proposed for completion after endorsement, including both non-critical repairs and any accessibility remedies that cannot be completed prior to endorsement. A letter of credit may *not* be substituted for this escrow.
  - 2. An additional cash amount (or letter of credit, at the option of the lender) of not less than 20 percent of the repair cost estimate will also be placed in escrow as assurance of completion of deferred repairs, provided however, that;
    - a. For 223(a)(7) transactions the additional amount shall be 10% of the repair cost; and,
    - b. The additional deposit may be reduced to 10% of cost for any repairs and alterations where:
      - i. a design professional has prepared construction drawings, and the borrower has engaged a non-identity of interest general contractor to execute the work per a form of contract acceptable to HUD; and
      - ii. the contract provides for the withholding of retainage in the amount of 10% of the value of work completed.
  - 3. The lender may release funds from the mortgage proceeds portion of the escrow in proportion of the cost of work completed consistent with HUD's instructions for disbursements from repair escrows. See Chapter 12 Section 17.
  - 4. Funds remaining in the escrow may be released to borrower when:
    - a. All repairs have been satisfactorily completed as determined by HUD;
    - b. Evidence of clear title has been provided to HUD; and
    - c. In cases where the cost of repairs and alterations exceeds \$400,000, the borrower (or the general contractor in cases where a construction contract was executed) has provided latent defect assurance in the form of an escrow in cash or letter of credit or surety bond (at the option of the lender) equal to 2½% (or a greater percentage as warranted) of the repair cost, to be maintained for fifteen months from completion of repairs. See paragraphs 8 and 9 of HUD-92476.1M for further details.
  - 5. Except in the case of existing insured projects, where the current balance in the Reserve for Replacement escrow may exceed the initial deposit otherwise required to provide a balanced financial plan for future capital replacement needs, funds deposited in the Reserve for Replacement escrow account at or after endorsement shall not be used for the completion of any immediate repairs and alterations.

M. Withholding of Excess Proceeds. In cases where completion of repairs is deferred and the mortgage amount exceeds the costs of refinancing and all required costs, including repairs (“cash out transactions”), the lender shall withhold 50% of the excess proceeds until all repairs and alterations are completed in a manner acceptable to the lender and HUD. The withheld funds will be added to the repair escrow. (See Chapter 8 for detailed escrow release instructions).

N. Completion of Repairs and Alterations.

1. If the borrower has not completed all repairs by the end of the repair period (including any HUD approved extensions), the lender will complete the repairs using the escrowed funds (but only to the extent of such funds) and will provide the borrower with a breakdown of these repairs and the cost(s) of completion (including administrative expenses). Funds remaining in the escrow account after completion of the repair work will be returned to the borrower less reasonable administrative costs incurred in completing the repairs.
2. Requirements after Completion of Repairs. In cases where all or a portion of the costs of repairs and alterations are required to support the loan amount and actual costs are less than estimated, the maximum insurable loan amount must be recalculated. If the maximum insurable mortgage is reduced due to lower actual costs, the borrower must use the excess proceeds for one or more of the following purposes:
  - a. Additional repairs approved by HUD and the lender; and/or
  - b. Prepayment of the mortgage in amounts equal to the scheduled monthly principal payments, with any remainder going to the Reserve for Replacements.

## 5.11 Cost Estimating for Lenders

Evaluating the estimates of construction cost prepared by the borrower, project architect, general contractor, needs assessor and/or construction analyst is a critical element of the lender’s underwriting task. It is the lender’s responsibility to assure that the borrower and third party professionals have developed and described costs in accordance with this Chapter 5. For new construction and substantial rehabilitation projects under Sections 220 and 221(d)(4) and 241(a) supplemental loans, replacement cost is one of the criteria used to determine the insured mortgage amount. In value-based programs, Section 231 and Section 223(f), replacement cost is a significant consideration in valuation, (except for properties 10 or more years old). Cost estimating consists of estimates of the construction costs for proposed improvements and/or repair and alteration costs for existing improvements.

A. Method of Estimation.

1. New Construction and Substantial Rehabilitation. The method should be similar to that used by general contractors. For new construction and substantial rehabilitation, data should be organized by trade division using the Construction Specification Institute (CSI) Format, then adjusted to reflect cost differences due to time, location, and price fluctuations. (HUD forms reflect the sixteen

division CSI format that was replaced in 2004 by an expanded, though comparable, format of fifty divisions.) The cost estimate may be prepared using a quantity takeoff or a square-foot and per-unit cost approach using established data and making adjustments.

The cost of repairs and alterations in substantial rehabilitation (less than gut rehabilitation) projects should be developed in the CNA e Tool but should be restated on HUD 92326 so as to compare estimated costs with the general contractor's HUD 2328 and so as to include consideration of the required prevailing wage decision.

By contrast, in gut rehabilitation, the general contractor's HUD 2328 costs (and/or the construction analyst's HUD 92326 cost) should be developed independently.

2. Repairs and Alterations Less than Substantial Rehabilitation. Needs assessors and lender construction analysts should develop and document costs in the CNA e Tool, estimating costs for each repair and component replaced or added new.
  3. Replacement Cost and Insurable Values. For casualty insurance purposes insurable values by building must be estimated assuming the task of reconstructing the building if it is destroyed, i.e. for the cost of replacing the building as if new (not restoring the structure as it was originally built using obsolete methods and materials.) Accordingly, for all existing structures replacement cost as if new (notwithstanding its condition) should be estimated for each building on a "per square foot" basis. This figure should be entered in the CNA on the Buildings Form. For new construction, estimated costs are "as if new" and so total estimated costs of buildings, (not site improvements) including soft costs and fees should be converted to a "per square foot" figure for each building and entered in the CNA on the Buildings Form. (See Appendix 5G, Section V).
- B. Data. The data source(s) used to prepare cost estimates must be documented. Acceptable cost data may come from completed comparable projects, benchmark amounts taken from actual project costs, and published data from construction cost data publishers. The CNA e Tool requires that replacement cost estimates briefly describe data sources/methods.
- C. Detailed Cost Estimates. The lender's construction analyst should use detailed plans and specifications supplied by the project architect and/or the needs assessor in the CNA as a basis for the cost estimate. Estimates must reflect the general level of construction costs in the locality where construction takes place. Costs must be projected to the midpoint of the estimated construction period. Davis-Bacon labor wage rates must be used for new construction and substantial rehabilitation. It is the lender's responsibility to obtain current Davis-Bacon wage rates from HUD and to assure that the project design team and general contractor are provided with the relevant and most recent, applicable wage decisions. For new construction and substantial rehabilitation, the cost estimate is tabulated on Form HUD-92326, and totals are reported in Sections G, M, and O of Form HUD-92264.
- D. Categories of Cost.
- The cost estimate consists of the following items:
1. Structures and Land Improvements include:
    - a. Dwelling structures. Costs of all residential buildings including footings and foundations.
    - b. Garages include all covered parking, from individual carports to complete parking structures.

For new construction and substantial rehabilitation, include free-standing garage structures with other accessory buildings on the Accessory Structures line on Form HUD-92326. Garages are reported separately on Line G.39 on Form HUD-92264 except when the garage space is an integral portion of a larger structure; in which case individual trade costs should be reported for the entire structure and not separately for the parking element. Similarly, costs should not be separated when accessory uses or commercial space is included as part of a larger dwelling structure.

- c. Parking and the CNA e Tool. Surface parking, including carports, are treated as site improvements for estimates developed in the CNA e Tool. In a building designed exclusively for parking (or if parking is a use of space in a larger building with other uses), all enclosed (garage) parking is treated as a common space even if spaces can be or are assigned to particular tenants. In some building configurations (e.g. attached townhouses) garages may be part of a dwelling unit and available only to a resident of that unit. Such garages are called “in unit” garages and the square foot area of such “in unit” garages is included in the area of the unit. “In unit” garages are not common space. Replacement cost is estimated for each building including all the uses of space in the building.
- d. Onsite land improvements make up the following trade line items on Form HUD-92326: Earthwork, Site Utilities, Roads and Walks, Site Improvements, Lawns and Planting, and Unusual Site Conditions. In the CNA e Tool onsite land improvements are identified as the need category “site systems.”
- e. In new construction and sometimes in substantial rehabilitation, unusual land improvements may be required to address conditions not typical to most construction in the locality (e.g. excessive excavation, rock excavation, cuts and fills, special foundations, high water table, problem soils, environmental remediation work or installations). These items are taken from the Unusual Site Conditions trade line item on Form HUD-92326, and are reported separately on Line G.36a of Form HUD-92264. They must be itemized separately because of their possible impact on site value. The lender’s construction analyst should consult with the lender’s underwriter and appraiser to define and quantify the need for unusual land or site improvements.
- f. Short extensions or connections of roads, walks, and utilities from project site boundaries to adjacent offsite public improvements are considered onsite land improvements.

2. Supplemental Cost Estimates include:

- a. Demolition. Demolition is defined as onsite work to remove existing structure, footings, foundations, and utilities to prepare a site for new construction.
  - 1) Include the removal and disposal of debris and fill and compaction of excavations. Include general contractors' and subcontractor’s overhead and profit in the estimate.
  - 2) Report on Form HUD-92326, under “demolition,” and Form HUD-92264, Section O. Appraiser will report Demolition costs in Section J of Form HUD-92264.
  - 3) Demolition should not be included in the construction contract.
  - 4) “Demolition” in this context does not include interior demolition within existing structures undergoing substantial rehabilitation.
- b. Offsite work is work not adjacent to project boundaries including utilities, walks, curbs, gutters, streets, drainage structures, landscaping, etc., that extend away from the project site.

These improvements are not included in the construction contract. Report on Form HUD-92326 and Section M of Form HUD-92264.

3. Cost Not Attributable to Dwelling Use. Cost-not-attributable consists of certain project amenities and uses other than dwelling uses. This cost is calculated by the cost analyst and used by the appraiser to increase the maximum mortgage amount under Criterion 4 of Form HUD-92264-A (Statutory maximum insurable mortgage amount per dwelling unit). The calculation is material only when project costs are likely to exceed the statutory limit and when a portion of those costs are not attributable to dwelling units. (Criteria 4 is typically not material in determining the maximum insurable mortgage, and accordingly costs-not-attributable need not be calculated except for properties where Criteria 4 is the determining criterion.

Cost-not-attributable must be included within the estimate of total structures and land improvements, and the costs must be itemized and reported separately on Form HUD-92326 and Section M of Form HUD-92264. The reason to estimate cost-not-attributable is to isolate construction costs for: (A) all improvements and for (B) selected improvements not related to or necessary for the dwellings (non-residential use). In each case the total is without general requirements and fees. The percentage of B divided by A is the percentage of costs not attributable. Such a percentage should be calculated for both residential buildings/spaces and commercial buildings/spaces in the project, and neither number may exceed a fixed maximum of 15%. The two are added together to obtain the project percentage of cost-not-attributable. This figure is used to allocate a proportionate share of all other mortgageable costs (fees, construction period interest and finance charges, etc.) between dwelling use and costs not attributable to dwelling use. The total of all costs-not-attributable times the maximum percentage loan-to-cost ratio is added to the maximum statutory limit calculated for the number of units by type. The sum is the maximum mortgage amount per Criteria 4. (See Appendix 5J).

4. Allowances and Fees. Allowances and fees are reported on Forms HUD-92326 and HUD-92264 as lump sum dollar amounts. Depending upon data, they may be calculated either as lump sums, or as percentages of subtotals which are converted to dollar amounts.
  - a. General Requirements (Job Overhead). Covers project specific overhead expenses. Calculate as a percentage of the sum of Total Land Improvements and Total Structures. The percentage amount is determined by the nature, difficulty, size of the project, and the characteristics of the neighborhood.
    - 1) Include:
      - (a) Supervision and job-site engineering;
      - (b) On-site job office expenses directly related to the project including clerical wages;
      - (c) Temporary buildings, tool sheds, shops, and toilets,
      - (d) Temporary heat, water, light and power for construction;
      - (e) Temporary walkways, fences, roads, siding and docking facilities, sidewalk and street rental;

- (f) Construction equipment rental not included in trade item costs;
- (g) Cleanup and disposal of construction debris not included in trade or sub-contract costs;
- (h) Medical and first aid supplies and temporary facilities;
- (i) Security guard wages and related costs;
- (j) Theft and vandalism insurance. (does not include Builders Risk Insurance);
- (k) Builders Risk Insurance may be included with general Requirements or Contractor's other fees only if paid for by General Contractor.

Builders Risk Insurance is separate from any theft and vandalism insurance policy provided by the general contractor. While Builders Risk Insurance may be placed by either the general contractor or the Borrower, it is common industry practice for the contractor to place the policy, with the contractor named as Insured, and the Borrower named as "Other Insured." Regardless of which party is responsible for payment, the Borrower must always be named as an Insured party, as per Builder's Risk Insurance requirements in Form HUD-92447, Property Insurance Requirements. If the contractor pays for the policy, the premium is included in the construction contract under General Requirements. However, if the Borrower pays for the policy, the insurance premium is included under Insurance on Line G-55, Insurance, of Form HUD-92264.

- 2) Salaries for site visits by owners, partners, or officers of the general contracting firm are included in General Overhead, except for payment for work done on the job by these individuals in a trade capacity, as laborers or supervisors.
- b. General Overhead. Covers contractor's home office or principal office and general business expenses. The amount is fixed at two percent of the sum of Total Land Improvements, Total Structures, and General Requirements.
- c. Builder's Profit or Fee. Builder's Profit or Fee is calculated as a percentage of the sum of Total Land Improvements, Total Structures, and General Requirements. The percentage amount is determined by the nature and location of the project and market conditions, and should be compared to the amount of the fee negotiated between the borrower and contractor for reasonableness. When the general contractor is an independent third party (no identity of interest with the borrower or sponsor) the Builder's Profit or Fee is an actual cost that must be paid to the general contractor. This applies to all non-identity of interest general contractors participating in any of HUD's mortgage insurance programs. When the general contractor has an identity of interest with the borrower, see paragraphs "d" and "e" below.
- d. Builder Profit in Value Based Programs-Section 231 Substantial Rehabilitation and 223(f). Except for certain affordable housing transactions, builder or general contractor profit or fee or development fees payable to affiliates of the borrower, (i.e., identity of interest participants), are not mortgageable costs and should not be included in the cost estimate. Reasonable and customary builder or development fees payable to unaffiliated third parties are eligible. (See Appendix 3B for treatment of fees in certain affordable housing transactions.).

e. BSPRA. Builder's and Sponsor's Profit and Risk Allowance (BSPRA) is a presumed profit for development and construction of a multifamily project. It is unique to applications for new construction or substantial rehabilitation under HUD's "cost based" programs (Sections 220 and 221(d)(4)) when an identity of interest exists between the borrower and the general contractor. BSPRA is always 10% of replacement cost not including land, but is itself not an actual cost or fee to be paid to the identity of interest general contractor and/or development entity (sponsor). It is used to calculate the mortgage amount in Criteria 3 on the HUD 92264-A. Its effect is to allow the identity of interest borrower/developer/contractor to contribute its presumed builder/developer profit (BSPRA) as equity whenever the mortgage amount is limited by Criteria 3. In a balanced summation of sources (loan proceeds, equity, etc.) and uses (costs of land, development, construction, capitalized interest, etc.) this presumed profit or BSPRA is added both to uses and sources. When Criteria 3 prevails, the mortgage amount will be a fixed percentage of costs. The "B" in BSPRA refers to the presumed fee of the builder or general contractor. The "S" refers to development cost of the sponsor/borrower outside the general contract and is called SPRA. The appraiser calculates the BSPRA amount and enters it on line G 68 of Form HUD-92264. When BSPRA is used, the lender should:

- 1) Calculate an equivalent builder's profit (the "B" portion of BSPRA) and an equivalent subtotal.
- 2) On the Builder's Profit line of Form HUD-92326 and on Line G 44 of Form HUD-92264, enter the word "BSPRA". The equivalent builder's profit calculated above is not included in the Total for All Improvements (bottom of Form HUD-92326 and Line G.50 of Form HUD-92264).

Use of BSPRA is not mandatory. A borrower may pay an affiliated general contractor an actual builder's fee or profit provided that: the amount of the fee is reasonable and customary; the form of the construction contract is cost plus fixed fee; the mortgagor and general contractor cost certify; and, the amount of the fee is funded in the construction escrow established at initial endorsement.

f. Architect's Fees. The source of this cost is the Owner-Architect Agreement, (see Section 5.3.D). If there are multiple prime agreements (e.g. separate architect and engineer), total all fees in line G 45 of HUD-92264 and itemize in Section O, Remarks. The lender's construction analyst should copy the fee amounts, unaltered, to the cost estimate. The construction analyst should document architect's fees and compare with existing fee data to determine reasonableness. The construction analyst should inform the lender's underwriter if fees are significantly different from the data range, but the fees should not be altered on the cost estimate without a prior meeting between the lender, lender's construction analyst, borrower, and project architect.

For new construction and substantial rehabilitation applications, fees should be documented as a percentage of the sum of Total Land Improvements, Total Structures, General Requirements, General Overhead, and Builder's Profit. The Architect's Fee usually consists of a design fee to cover the cost of the preparation of all construction documents (working drawings and specifications) up to start of construction; it typically represents 75 to 80 percent of the total fee. The Architectural Supervision fee covers the cost of the project architect's construction

inspections, reports, and preparation of change order requests; it typically represents 20 to 25% of the total fee.

- g. **Bond Premium.** Covers the cost of Payment/Performance Bonds used to ensure completion of construction in event of a default by the general contractor. The bonding or surety company determines the premium or cost based on its perception of risk in light of the contractor's financial capacity and performance history and the nature of the work.
  - h. **Other Fees.** Costs of various required items and services can vary greatly among jurisdictions and localities. Other Fees can be paid either by the borrower or the general contractor. The borrower should submit an itemized list of all project-related Other Fees as an aid to the construction analyst. Other Fees can include:
    - 1) Site and topographic surveys;
    - 2) Subsurface exploration (test borings);
    - 3) Soil tests, concrete tests, and other construction testing;
    - 4) Fees for utility taps and connections;
    - 5) Impact fees for public infrastructure;
    - 6) Building permits and licenses; and
    - 7) General Contractor's cost certification audit fee (if required). NOTE: The borrower's cost certification audit fee is not to be included in Other Fees since it is recorded separately on Line G. 66 of Form HUD-92264.
    - 8) Builders Risk Insurance may be included with general Requirements or Contractor's other fees (only if paid for by General Contractor).
  - i. **Furniture, Fixtures, and Equipment (FF&E)** includes substantial indoor and outdoor furniture and equipment (e.g. trash dumpsters, pool or recreational equipment, permanent lobby or reception area furnishings). It may not include titled vehicles, minor items of relatively insignificant cost such as furniture accessories, income from rental unit furnishings, hand tools and hand power tools, or expendable items. An itemized schedule of FF&E with cost for each item will be submitted with the cost documents and reviewed by the lender's construction analyst for acceptability. Costs may include only delivery and placement of the item. The dollar amount of FF&E will be reported on line G.60 of the HUD-92264; "AMPO percent (nonprofit only)" will be lined out and substituted with "FF&E".
5. **Construction Time, Construction Period.** The construction period is measured as a number of consecutive months of elapsed time and will vary depending on the scope of work, size and building type and construction technologies used. For any job with Level 2 and/or Level 3 alterations and any substantial rehabilitation or new construction, a job schedule must be established. The schedule is not a simple calendar, but rather a graph or table illustrating both elapsed time for particular tasks, trades or discrete portions of the work as well as the necessary sequence or order of tasks or trade items including noted dependencies among tasks, commonly referred to as a work breakdown schedule. For substantial rehabilitation and new construction, report the construction time in months on Line G. 52 of form HUD 92264. This figure will be used to estimate the amount of capitalized interest and carrying costs during the construction period.

- E. CNAs are required for all applications. For gut rehabilitation and new construction, the lender's construction analyst may prepare the CNA based on the project architect's proposed plans and specifications assuming construction completion (that is, the CNA will estimate only future repairs and replacements and not immediate construction). In other applications the CNA is prepared by the needs assessor based on existing conditions. In either instance it is the lender's responsibility to assure that the estimated remaining useful life of components and the costs of future replacements and any immediate repairs are estimated consistent with Chapter 5 and its appendices. The lender's underwriter will develop a financial plan for funding future capital needs by using the "Financial Factors form" (See Appendix 5G). Based on the financial factors, the CNA e Tool will generate a schedule of annual deposits to the Reserve for Replacement (R4R) escrow. In accordance with Appendix 5G, the lender must adjust the financial factors so as to plan funding sufficient to pay estimated future capital needs. The borrower's schedule of deposits to the R4R will be based on actual expected capital needs, not on a percentage of construction cost or mortgage amount.
- F. Whether prepared based on conditions at an existing property or for a property to be built, the CNA e Tool will generate an estimated replacement cost for each structure, which should be used as the Schedule of Insurable Values, (HUD form 92329). In the case of CNAs based on construction to be completed, the lender's construction analyst should ensure that the replacement cost per square foot entered on the "Buildings form" of the CNA e Tool is consistent with cost estimates for each identified building.

## **5.12 Cost Package for Firm Commitment**

As part of the Firm Commitment application, the lender's construction analyst will prepare a detailed cost estimate and all required reports and recommendations as described below. For streamlined processing, these same documents will be prepared in draft consistent with the draft drawings and specifications. However, these documents must be corrected as needed and submitted in final form based on the final drawings and specifications no later than 30 days prior to Initial Endorsement.

### **A. Required Forms.**

1. Form HUD-92326. Used for preparation of detailed construction cost estimate for new construction and substantial rehabilitation projects.
2. Form HUD-92331-B. Used to make detailed comparison of trade line items between Estimators' cost estimate (HUD-92326) and Contractor's trade payment breakdown (HUD-2328) for new construction and substantial rehabilitation projects.
3. Form HUD-92329. Property Insurance Schedule, prepared in the CNA e Tool, used to determine the Insurable Value for each project structure and the aggregate sum for all structures for all applications. Form HUD-92447, Property Insurance Requirements, will be prepared by HUD and provided to the lender at closing.
4. Form HUD-92264. Project Income Analysis and Appraisal.
  - a. Section G. Estimated Replacement Cost, Line 36a through 52 is used to summarize Total Structures, Land Improvements, General Requirements, and Fees from Form HUD-92326, and

also records estimated construction time. This section is primarily used for substantial rehabilitation and new construction.

- b. Section M. Used to summarize Cost Not Attributable to Dwelling Use (lines 10 through 15), and Offsite Requirements (lines 16 and 17).
- c. Section O, Remarks. Used to explain Unusual Land Improvements, Other Fees, itemization of professional fees (e.g. engineers), overall difference between lender's and borrower's cost estimates, and other cost items.

B. For new construction and substantial rehabilitation proposals, prepare detailed cost estimate on Form HUD-92326 using instructions in Section 5.11; sign form on the "Estimate Prepared by" line and certify. Refer to standard certification in Chapter 11, Section 11.2.

C. Resolve differences in lender's and contractor's construction cost estimates.

Before the Firm Commitment application can be submitted for HUD review, the construction cost estimates prepared by the general contractor and the lender's construction analyst must be reconciled. The lender's analyst is responsible for resolving major differences between the two estimates. When the two estimates are generally consistent, the lender may use the contractor's cost figures as shown on Form HUD-2328 as its cost estimate. The lender's construction analyst will use the following review procedure for new construction and substantial rehabilitation applications:

1. Prepare trade line item comparison of lender's and contractor's cost estimates using Form HUD-92331-B.
  - a. Enter costs from Forms HUD-92326 and HUD-2328. For multiple-structure type projects, a separate HUD-2328 must be submitted for each structure type, and a master HUD-2328 for the entire project.
  - b. Calculate and list line item percentage differences.
2. Review trade line item differences and note all variations beyond normal ranges. The range of trade line item differences varies from trade to trade. Major trades (e.g. engineers, carpentry) should have a smaller range difference than minor trades (e.g. sheet metal). The analyst should judge the variations based on established data.

Front-end Loading: The analyst should be alert for a pattern of front-end loading in trade items, where the contractor inflates costs for trade items needed early in the job schedule in order to secure more mortgage proceeds early. Such a pattern may indicate inadequate working capital or risky business practices by the contractor. Advances of funds from loan proceeds should always accurately reflect the cost of work completed, and payment should follow, never precede, the completion of work or portions thereof for which payment is requested.

3. Meet with contractor to discuss and resolve all questionable trade line item differences. The resolution process may result in either the estimator or the contractor, or both, recalculating costs of various trade line items based on discussions.
  - a. If differences are resolved, accept costs in Form HUD-2328 and use as lender's Cost Estimate in Form HUD-92264.
  - b. When dealing with suspected front-end loading, require rigorous documentation of early trade items that are higher than normal.
  - c. If differences cannot be resolved, do not accept costs in Form HUD-2328.

- 1) Use the construction analyst's cost estimate as the lender's cost estimate.
  - 2) Inform the lender's underwriter that the contractor's HUD-2328 is unacceptable.
  - 3) Advise the lender's underwriter to meet with the borrower and the contractor for further attempts at resolution.
- D. Prepare cost portions of Form HUD-92264, using instructions in Section 5.11. Sign form in the "Cost Processor" box and certify (see standard certification in Chapter 11, Section 11.2).
- E. Property insurance schedule, Form HUD-92329, based on CNA e Tool replacement cost per building. Common equipment that serves the entire property or portions thereof (e.g. a boiler and cooling tower assembly) should be included with the cost of the building where it is located and not prorated among the buildings served by the equipment.
- F. Prior approval of identity-of-interest subcontractors' proposed costs including overhead and profit is required.
1. An identity of interest is a relationship that exists giving the borrower or general contractor apparent control or influence over a subcontractor, equipment lessor, material supplier, or manufacturer of industrialized housing. (See General Contractor's cost certification instructions in Chapter 13 - Cost Certification, for definition of relationships).
  2. Requirements. When subcontractors, material suppliers, or equipment lessors have an identity of interest with a borrower or general contractor, the lender must approve the subcontract amounts, including specific amounts for subcontractor general overhead and profit.
  3. Timing. Approval is required before work begins under the subcontract. Failure to secure prior approval will result in the disallowance of the total general overhead and profit of the subcontractor at cost certification.
  4. Request for approval (with the subcontracts, agreements, or leases) is submitted to the lender's construction analyst, whose recommendations must include:
    - a. Acceptability of the documents.
    - b. Reasonableness of guaranteed maximum prices for the subcontract work.
    - c. Appropriateness of general overhead and profit dollar amounts.
  5. Mandatory Conditions for Approval.
    - a. Subcontracts:
      - 1) Must be a separate subcontract for each trade.
      - 2) Must clearly identify scope of work.
      - 3) Must be on a cost plus fixed fee basis:
        - (a) Guaranteed maximum dollar amount for work.
        - (b) Specific dollar amount for general overhead and profit.
      - 4) Disapprove "paper conduit" arrangements where work is to be done by general contractor personnel or other subcontractors, suppliers or lessors.

b. Subcontract prices: For this criterion, recent reliable data is a better test than whether higher bids were submitted.

1) The total price must not exceed the amount shown for the trade item on the accepted Form HUD-2328.

2) Total price must not exceed reasonable prices taken from available data.

NOTE: The lender's cost analyst must resolve disagreements in trade prices with the subcontractor.

c. Overhead and Profit. The amounts for general overhead and profit shall be no higher than the typical prices for the specific trade.

d. Subcontractor entity. The burden of proof of 1, 2, and 3 below is on the subcontractor.

1) The firm must operate and have documented experience as a subcontractor for the specific field covered in the subcontract.

2) Must control labor, materials, and equipment typical for the trade.

3) Must do significant business in its specific field with borrowers and general contractors having no identity of interest.

6. If total of all identity of interest subcontracts, purchases and leases is less than ½ of 1 percent of the mortgage amount, the requirements for each identity of interest subcontractor to cost certify may be waived by the MF Regional Center/Satellite office Director upon notification by the lender.

7. Prepare letter of approval or disapproval to the borrower or general contractor. Letter must address all mandatory conditions.

a. Approval will indicate any conditions, including whether or not subcontractor must cost certify.

b. Disapproval will state the reason for disapproval and indicate any cost certification requirements.

#### G. Cost Concerns for Substantial Rehabilitation.

The detailed cost estimate should include and evaluate the following:

1. Interior demolition and removal of: floors, walls, roofs, doors and windows, finishes, cabinets, appliances, plumbing, HVAC, and electrical, including boilers and central air conditioning. Also includes abatement of asbestos and lead-based paint. Enter amount in Special Construction trade line in Form HUD-92326. If individual trades include removal (e.g. remove and replace cabinets), removal costs may be included in the trade line item.

2. Site preparation demolition is not part of the Construction Contract and should be estimated and recorded in the same way as for new construction.

3. Allowances and Fees for substantial rehabilitation, especially General Requirements and Architect's Fees, are calculated the same way as for new construction, but they should reflect the

risk and responsibility inherent in rehabilitation and consider the location of the project. It is recommended that the construction analyst keep separate data for this item.

4. Rehabilitation time is determined the same way as construction time for new construction, but the data used must take into account the time required for interior demolition, as repair and rehabilitation cannot begin until such demolition is complete.
5. Rehabilitation cost not attributable to dwelling use includes an “as-is” value for non-attributable items in addition to a value for actual work performed. Calculate by using the format in the Appendix 5J.2. The construction analyst completes steps 1, 2, and 3; steps 4 through 8 are completed by the appraiser.
6. Contingency reserve amount is based on available data for the type and condition of structure. Calculate as percentage of the sum of structures, land improvements, and general requirements. Percentage ranges from 10 to 15%, depending on the condition of the project, extent of rehabilitation, and experience and financial capacity of the borrower and contractor. Enter amount on line G.71 and in Section O of Form HUD-92264. Subject to lender and HUD approval, the Borrower may elect to apply any funds remaining in the substantial rehabilitation construction contingency account after completion of the approved rehabilitation, to:
  - a. further improvements, betterments or upgrades to the property,
  - b. an initial deposit to the Reserve for Replacement account; or
  - c. reducing the mortgage balance.

If excess funds from contingency are used for betterments, those additional improvements will not be considered as the basis for a request for an increased mortgage amount.

#### H. Cost Concerns for Refinance/Acquisition-Section 223(f) and 223(a)(7).

1. The lenders must determine that:
  - a. The CNA describes, quantifies and estimates immediate repairs and future needs consistent with Chapter 5 and Appendix 5G and that replacement costs data sources are identified;
  - b. The assessed remaining useful lives of components and estimated useful lives for alternatives are justified whenever the entered values depart from the Standard Estimated Useful Life Table;
  - c. The flags obtained from validation of the needs assessment via the Validation Engine of the CNA e Tool are either removed by amending the needs assessment or explained in a flag comment.
2. The cost portions of HUD 92264 should be completed based on the replacement cost of buildings as reported in the CNA e Tool.
3. The lender must review the needs assessor’s “Repair, Replace Add New Recommendations” and determine that life safety and accessibility repairs have been identified with a “yes” in the appropriate indicator, and that the recommended timing, cost and other action are appropriate and consistent with observed conditions.

4. The lenders should review any immediate repairs for 223(a)(7) applications to assure that repairs are limited and do not exceed routine maintenance, except for needed remedies for accessibility deficiencies.

## **5.13 HUD Procedures**

All applications will be assigned to a Senior Underwriter or underwriting team by the Production Chief. The underwriting team will complete an early warning system (EWS) review of each application and identify which applications can be assigned to and reviewed by a single underwriter and which may require the assistance of the Technical Branch Chief and/or a HUD construction analyst (architect, cost analyst). In general all new construction and substantial rehabilitation applications should be reviewed by a construction analyst. In addition, refinance and acquisition applications with combinations of repairs and alterations exceeding \$15,000 per unit in cost and/or including Level 2 and Level 3 alterations should be reviewed by a HUD construction analyst. Applications for Section 223(f) for properties less than 10 years old and for Section 223(a)(7) should not require the assistance of a construction analyst unless the CNA contains a corrective action plan for accessibility deficiencies or the HUD underwriter observes that such a plan is required but not submitted. Section 223(f) applications for properties older than 10 years with repairs and Level 1 Alterations will require the underwriter to determine whether any issues are observed that might require a technical review.

- A. When engaged to complete a technical review or consider a particular lender exhibit, the HUD construction analyst should not redo or correct the lender's work. Instead the review should be summarized in writing for the HUD underwriter.
  1. Review the lender deliverables for completeness;
  2. Examine the review report and the A/E and cost exhibits and recommend either acceptance, acceptance assuming specified modifications, or rejection of the A/E and cost portion of the Firm Commitment submission; report to the underwriter on the form(s) at Appendix 5F and following as appropriate for the application stage and program.
- B. Any application for an existing property proposing repairs and alterations in any combination that results in uncertainty about program eligibility (refinance/acquisition vs. substantial rehabilitation) should be reviewed by the HUD construction analyst, who shall review the immediate repairs identified in the CNA e Tool.
  1. The costs of all repairs should be totaled and compared to the cost per unit threshold (5.1.D) adjusted for the applicable high cost factor. If the total cost of immediate repairs exceeds the threshold, the application is for substantial rehabilitation.
  2. All the immediate repairs should be sorted by "Need Category" and "Need Item" so as to establish cost-by-system (5.1.B) and the cost-by-system compared to the estimated replacement cost for the entire system as configured at the property. If two or more of the systems exceed 50% replacement measured by cost, then the application is substantial rehabilitation.

### C. CNA e Tool and the Single Underwriter Way of Work.

The Reviewer Tool portal of the CNA e Tool is available only to authorized HUD (and USDA) staff. Use of the tool is to be consistent with the single underwriter approach and requires that completed work be presented to senior managers before a CNA is returned to a lender with comments or is approved as part of an underwriting decision on an application for mortgage insurance. Each user will be assigned at least one of three possible roles:

1. **Assigner.** Assigners generally will include the Production Chief, and Branch Chiefs and may include Senior Underwriters. Assigners should have dual roles, i.e., assigners typically will also have a reviewer role. Assigners receive nightly reports on all CNAs submitted to HUD including information on the program for which application is made or the purpose of the CNA, the name and location of the subject property and the status of the CNA (submitted, under review, ready for decision, returned and approved.). Assigners will also receive a nightly workload report indicating the number of CNAs assigned to each reviewer and certain information useful to assess relative workloads. Using these reports assigners will allocate or “assign” submitted CNAs to staff who have the reviewer role. Assigner’s also have the responsibility to open CNAs made “ready for decision” by their staff, and to modify or edit the reviewer’s comments. If an assigner desires a reviewer to modify comments or reconsider issues or seeks additional review from technical staff, the assigner identifies the reviewer and assigns the CNA to that reviewer. When satisfied that the review is complete and that comments or identified issues require a lender response, the assigner “returns” the CNA to the lender. When the lender addresses comments and resubmits the CNA the process is repeated, until the Assigner is satisfied that all CNA and other underwriting requirements have been addressed and a Firm Commitment can be issued, whereupon the assigner “approves” the CNA. Attachments and reports from the approved CNA may be printed for use as attachments to the Firm Commitment as needed. The approved CNA, including all attachments, is recorded permanently in the CNA e Tool database and can be retrieved for comparative purposes and/or for use in asset management functions.
2. **Reviewer.** Reviewers receive assignments from Assigners. Generally reviewers are underwriters and/or technical staff. The CNA e Tool reviewer assigned to the application can open the CNA in the Reviewer Tool. Reviewers have access only to CNAs assigned to them. Reviewers use the Reviewer Tool to analyze the assigned CNA, enter comments both general and specific and upon completion of review indicate that the CNA is “ready for decision.” A Reviewer may “reassign” to another reviewer a CNA assigned to him which enables staff to share work or solicit assistance. When satisfied that all relevant and material issues have been identified and noted in comments, the reviewer changes the CNA status to “ready for decision” whereupon the assigner is able to consider the reviewer’s work, modify the reviewer’s comments and either assign it back to the same or another reviewer for further work, return it to the lender for the lender to address comments, or approve the CNA.
3. **Viewer.** A viewer is any staff person who regularly needs to see CNAs but not act on them.

D. Work-sharing.

The Reviewer Tool portal of the CNA e Tool supports work-sharing across all HUD offices geographically and among different program offices, e.g. Office of Multifamily Production, Office of Recapitalization, and Office of Asset Management and Portfolio Oversight.

E. Detailed Instructions for Users.

Detailed instructions for users are available at the CNA e Tool homepage (url to announced) and specifically in the CNA e Tool Internal Users Manual.

F. Timely consultation and review by other, appropriately experienced, HUD staff may expedite applications and avoid delays at closing. In particular, survey issues, proposed easements and joint use and access agreements that impact design, construction or operating expense estimates should be reviewed by Regional Counsel before final underwriting is completed.

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## **Chapter 6 Formerly Cost**

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This chapter has been combined with Chapter 5 and is reserved for use in future MAP Guide revisions.

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# Chapter 7

## Valuation Analysis & Market Study Guidance

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### 7.1 Introduction

- A. This chapter provides guidance on HUD's Valuation and Market Study requirements for Third-Party MAP Appraisers, MAP Lenders and Underwriters, and HUD staff involved in reviewing appraisals.
- B. The Valuation Analysis evaluates the existing or proposed project as collateral and security for a long-term mortgage. Depending on program requirements, this includes an estimation of the market value of the land and/or the property and an analysis of the market need, location, residential and commercial rent and other income, and operating expenses of the project.

The Valuation Analysis develops conclusions with respect to feasibility, suitability of improvements, extent, quality, and duration of earning capacity and other factors that have a bearing on the economic soundness of the project. The objective of the appraisal is to establish value for use in underwriting the supportable loan amount and to determine if the project will meet the market demand at rents that will pay operating expenses, debt service and provide for sufficient deposits to any reserve accounts.

- C. The Department has statutory authority (12 USC 1708(g)) to prescribe standards for the appraisal of all projects to be insured by the Federal Housing Administration. Such appraisals shall be performed in accordance with uniform standards, by individuals who have demonstrated competence and whose professional conduct is subject to effective supervision. Under the MAP Program, HUD relies on the MAP Approved Lender to provide such supervision through the underwriting, loan approval, quality control, and compliance program and protocols. Additionally, the Department requires a USPAP Compliant appraisal review by a HUD Review Appraiser (HRA) for medium to high risk transactions.
- D. The Multifamily Regional Center Director has authority to rely on the lender's appraisal review without a HUD staff appraiser review. Exercise of such authority may be appropriate for low-risk and some medium-risk transactions in which the application is complete, reliable and not particularly complicated. In all cases, a qualified HUD employee must review each appraisal for compliance with USPAP and HUD requirements.
  - 1. Low Risk Transactions – Includes most Section 223(f) projects with minimal repairs.

2. Medium Risk Transactions – Includes 223(f) projects where significant repairs may be required, RAD or Tax Credit projects as well as Substantial Rehabilitation projects where there is minimal tenant displacement. This does not include projects that meet the criteria for large loan underwriting. New Construction projects may be included where the underwriter is experienced and the market is well established.
3. High Risk Transactions – Include most New Construction Projects and projects that meet large loan underwriting criteria. Also includes transactions with leasehold (versus fee simple) ownership interests.

## **7.2 Selection of Appraisers and Market Analysts**

- A. The lender is responsible for the selection and approval of appraisers and market analysts who are familiar with MAP guidelines. Lenders must ensure that each appraiser and market analyst selected is qualified to appraise or perform market analyses for multifamily properties by reviewing their education, quality, and frequency of multifamily appraisal experience, sample appraisals and market studies, professional affiliations, and state licenses or certifications. The ability to complete various HUD forms related to the appraisal, e.g. HUD-92264, 92273, 92274 etc., is also a requirement. The lender may assist the appraiser in the preparation of these forms, but the appraiser must sign them. The HUD 92264-A is an underwriting form prepared by the MAP Lender’s underwriter and is not a required appraisal exhibit.
- B. Should the lender have difficulty finding a Certified General Appraiser, the Appraisal Subcommittee of the Federal Financial Institutions Examination Council maintains a national registry of Certified General Appraisers who are authorized, under Federal law, to perform appraisals in connection with federally related transactions. The lender may review this list at <http://www.asc.gov>, although inclusion on this list is not an indication of competency to perform multifamily appraisals.
- C. The appraiser or the market analyst must be independent of and may not be affiliated with the loan originator, broker, developer, borrower, MAP Lender or any individual or institution involved in any other financial role in the application. The underwriter shall not act as the appraiser or market analyst.
- D. The MAP Lender’s responsibility for supervision of the appraisal and market study (and any other third party reports) requires that the third-party appraiser be selected by the MAP Lender’s underwriter. The appraisal must be ordered and paid for by the MAP Lender and not by the originator, broker, developer or borrower. The appraisal must identify HUD as an intended user of the report. Appraisals prepared by any entity not engaged and paid for by the lender, are not acceptable and will not meet HUD’s appraisal requirements.
- E. The market study should be ordered and paid for by the lender. However, a market study that has been prepared for the borrower by a third party market analyst and meets all other market study requirements of the Guide, including timeliness, is acceptable. The lender is responsible for the review and acceptance of all market studies submitted with the application.

- F. There shall be no discrimination on the basis of race, color, nationality/ethnicity, religion, sex, disability, familial status, LGBT and age in the selection of an appraiser or market analyst.
- G. HUD reserves the right to examine the credentials of all appraisers and market analysts hired by the lender, and to reject any individuals that it considers unqualified. HUD staff with concerns about a third party's capability, competence or experience should contact the Multifamily Asset Counterparty Oversight Division (MACOD) through their supervisory chain. HUD does not formally approve appraisers or appraisal firms as being "MAP Approved." Rather, the MAP Lender is responsible for ensuring the professionalism and competence of its contracted appraiser and the quality of the ultimate appraisal product submitted as a component of the lender's application.
- Note: HUD will not reject any third-party contractor without having first issued warning letters to the lender highlighting the areas of non-compliance in their submitted reports. Third-party contractors will be afforded the right of appeal and due process in defending their work, consistent with MACOD procedures.
- H. The most current appraiser Certification required by Uniform Standards of Professional Appraisal Practice (USPAP) must be signed by the appraiser. In addition, the appraiser must include a certification that the racial/ethnic composition of the neighborhood surrounding the project in no way affected the appraisal determination.

## **7.3 Third Party Appraiser and Market Analyst Qualifications**

### **A. Appraiser Qualifications**

1. Each appraiser must meet the following minimum qualification requirements:
  - a. Be a Certified General Appraiser under the appraiser certification requirements of the state in which the subject project is located;
  - b. Be currently active and regularly engaged in the appraisal of multifamily properties;
  - c. Meet all requirements of the Competency Rule described in USPAP, which applies to each certified appraiser who signs the report. If any of the persons involved in preparing the report is a trainee acting as an assistant, this must be disclosed in the report;
  - d. Have at least three years of income project appraisal experience;
  - e. Be knowledgeable concerning current real estate market conditions and financing trends in the geographic market area where the subject project is located, and be experienced in appraising multifamily properties with the complexity and characteristics similar to those of the subject project. If the subject contains commercial space, Low Income Housing Tax Credit (LIHTC) or other subsidies, the appraiser must have acceptable prior experience in the appraisal of comparable properties.
2. These requirements apply to each Certified General Appraiser signing the report. It is not

permissible for an appraiser who is not certified in the appropriate jurisdiction to circumvent certification requirements by having a locally certified appraiser co-sign the report. Appraisers who are not certified in the appropriate jurisdiction may not perform the required project inspections of the subject or comparable properties. The appraiser must disclose any of the persons involved in preparing the report who are not certified general appraisers and are acting as an analyst, assistant or trainee.

3. Temporary Certification. Temporary certifications are permissible; however, the above competency requirements still apply. The appraiser is responsible for checking the accuracy of all information obtained from local sources and must indicate the names of all individuals who provided material assistance in preparing the appraisal. A temporary certification must be obtained prior to beginning the assignment. The lender may select appraisers who have temporary certification who have documented how they will achieve competence in the subject area in accordance with USPAP.

## **B. Market Analyst Qualifications**

1. Each Market Analyst must meet the following minimum qualification requirements:
  - a. Have at least 3 years of experience in performing market studies for income producing properties,
  - b. Be currently active and regularly engaged in performing market studies for multifamily properties,
  - c. Be knowledgeable concerning real estate market conditions and financing trends in the geographic market area where the project is located, and
  - d. Be experienced in performing market studies for multifamily properties with the complexity and characteristics similar to those of the subject project. If the subject contains commercial space, LIHTC or other subsidies, the market analyst must have acceptable prior experience with comparable properties.
2. MACOD will investigate any Regional Center or Satellite Office complaints that a lender is contracting unqualified or unlicensed appraisers or market analysts.

## **7.4 HUD Workload Sharing Reviews of Appraisal and Market Study Reports**

- A. Workload Sharing. With the reorganization of Multifamily Production, HUD is using Workload Sharing, whereby certain underwriting functions may be transferred to staff who are in locations that are distant from the project under review. These functions may include, but are not limited to, appraisal and market study review.

- B. Third Party Appraisers and Market Analysts working on MAP transactions should assume that their work will be subject to review under Workload Sharing. HUD staff that are performing reviews under Workload Sharing may not always be able to physically inspect the subject and comparables, and the market information used to verify and determine the validity of conclusions may be from nationally purchased data sources such as, but not limited to REIS. (Note: In all cases the project will be physically inspected by a qualified HUD staff member.)
- C. Project locations that are outside the urbanized areas covered by these sources are affected by market forces for which there will be little property specific information available to HUD staff. HUD staff will typically have the same level of knowledge of a particular project or location as the professional who has done the extensive research and analysis necessary to develop credible conclusions. The review function would not be efficient or sensible if it involved the same level of time required to develop and prepare an appraisal report/study. However, reviewers must take the time needed to make contacts with market participants to develop as much knowledge as possible to reach reliable conclusions about the work under review.
- D. Third party report providers and MAP underwriters must ensure the application and supporting material contain sufficient information for remotely located HUD staff to make a decision. For projects that are in a location that are not adequately covered by national sources, the reports must reference the local sources and contrast them with recognized national sources. The goal is to assure that the reviewer can better understand the nuances of the local market.

## **7.5 Content and Format of the Market Study**

- A. Purpose and Focus of the Study. The purpose of the market study is to assure that there is enough sustainable demand for additional units without adversely impacting the existing supply, so as to maintain a balanced overall market. The focus of the market study is on the overall demand within a defined market area, and of the proposed project's ability to capture and sustain a share of the total (incremental demand). The primary and secondary market areas analyzed by the lender's market analyst may be narrower in scope than the market analysis prepared by the HUD Economic and Market Analysis Division (EMAD), which analyzes the broader Metropolitan Statistical Area (MSA), county, or smaller submarket area as appropriate. The market analyst must, however, also discuss the larger MSA or county. The study must estimate the number of renter households with sufficient incomes to afford the type of housing at the rents proposed at present, as well as any expected changes in rental housing demand in the foreseeable future (typically the next 3 to 5 years). The study must also identify and discuss any risks associated with longer-term changes in rental housing demand (during the term of the mortgage). In addition, the study must estimate the number of units that the market could reasonably absorb over a specified forecast period, which is typically 3 years, taking into consideration competitive units in the existing inventory, units currently under construction, and units in the planning pipeline, as well as the gross and contract rents of those units.

For projects designed for the elderly, families, and persons aged 62 and over, the study must define the age restrictions, the anticipated household configuration and any anticipated household services. The study must also estimate the number of elderly households with sufficient incomes to afford the type of housing and services (if any) under study, any expected change in the number of such households, the proportion of those households that would need and demand such housing, and the number of units that the market could reasonably absorb and sustain over the forecast period.

No market study, other than that which would be provided in the appraisal, is required for projects with 90% or more project based rental assistance.

B. Executive Summary. All market studies must contain an Executive Summary with a concise summary of the data, analyses and conclusions, including the following:

1. a description of the site and the immediate surrounding area;
2. a summary of the project, including the proposed targeted population;
3. summary statements describing the condition of the economic, demographic and competitive environment;
4. a statement of key conclusions reached by the analyst; including but not limited to the Net Demand and Effective Demand for the subject, and forecast average annual change in the number of households for a specified period of time;
5. a summary of competitive advantages and disadvantages, and issues that will affect the project's marketability, performance and lease-up, as well as points that will mitigate or reduce any negative attributes;
6. The number of units currently under construction in the development pipeline;
7. a statement of the analyst's opinion of market feasibility of the project; and
8. recommendations and/or suggested modifications to the proposed project, if appropriate.

C. Description of the Proposed Project. The market study must include a thorough description of the proposed project, including:

1. The number of units by type and size with information on the number of bedrooms and bathrooms, structure type, square footage, etc. Actual (paint to paint) size should be noted as well as the size in published brochures or other media.
2. The proposed contract, utility allowance and resulting gross rents by unit type. (Gross rent is defined as the cost of renting the unit, including the cost of resident paid utilities.)

3. Description of any income or rent restrictions imposed on the project by the use of public financing and/or subsidies (e.g., LIHTC, tax-exempt bonds or subordinate loans). Identify any project-based rental subsidies to be offered, specify the number of subsidized units, the type and form of the assistance, and rent levels related to market rents.
  4. Utility policy in terms of which costs are paid by the tenant and which costs are paid by the owner/landlord.
  5. The unit features, project amenities and services and associated cost.
  6. For rehabilitation projects provide:
    - a. Description of the proposed scope of rehabilitation including a breakdown of hard and soft costs, if available.
    - b. An estimate of total construction cost and cost per unit.
    - c. Identification of the existing unit mix and rents including any existing housing subsidies. Current and proposed rents should be compared.
    - d. Current and historical (if available) occupancy information.
    - e. An analysis of the current rent roll (if available) to determine if existing tenants will remain income qualified and/or able to afford the proposed rents.
  7. The project location in terms of:
    - a. Characteristics of the neighborhood in relation to schools, transportation, shopping, employment centers, social and community services, etc., to include a study of the adequacy of the public facilities that will service the site. The report must include a map showing the site and important neighborhood facilities and amenities.
    - b. Any other locational considerations relevant to the market and marketability of the proposed project.
    - c. A conclusion concerning the suitability/appropriateness of the site for the proposed use.
  8. Other Characteristics, if any, of the proposal that will have a specific bearing on its market prospects and overall marketability.
- D. The Primary Market Area (PMA) is the geographic area in which units with similar characteristics, e.g., number of bedrooms and rents, are in equal competition. The location of the competing projects and where the majority of the residents be derived from must be discussed. The size of the PMA for general occupancy rental housing can vary significantly depending on the extent and location of comparable and competitive products within a specific area and geography. In some cases, both a primary and secondary market area must be defined. When defining the boundary of a market area,

the analyst should consider the locations of comparable and competitive rental developments (existing, under construction and developments in planning) and commuting times from employment. Data on place of work or residence, population from the Decennial Census, American Community Survey (ACS), private data services and local sources will aid in this determination.

The market area analysis must include the following:

1. A legible map of the PMA, showing delineated boundaries, location of the subject, major highways and thoroughfares, geographic features like rivers and lakes, and political divisions such as state lines and city limits. The map must have a title, bar scale, north arrow and legend.
2. A description of the geographic boundaries of the PMA and a justification for the delineation, including a discussion of the location of competitive housing, relevant services and amenities and concentrations of employment opportunities.

E. Economic Context. The market study must include a thorough description of the current and forecast economic characteristics and conditions of the PMA, county, "micropolitan" or metropolitan area (whichever is applicable). The description is necessary to provide background and justification for the subsequent demographic analysis and estimates of demand for additional rental housing. A discussion of current economic conditions and employment characteristics must be discussed, including:

1. Identification of growth sectors in the economy and emerging trends, including a detailed discussion of the sectors in the economy that have a major impact on the local housing market, such as military facilities, colleges and universities, federal and state government, major employers or tourism.
2. A study of recent trends in employment, including unemployment statistics, new job creation or loss, with a detailed discussion of: Historical nonfarm and resident employment levels and changes;
3. Any anticipated changes in employment as a result of expected closings, openings, expansions or cutbacks by leading employers, with a particular emphasis on how this would affect the rental market during the forecast period, including any seasonal employment markets.
4. Information on the types of jobs being created and lost, including data on pay scales and how these wage levels relate to the affordability of the proposed rental units.
5. List of major employers in the PMA, the type of businesses and the number employed.
6. In relevant markets (such as resort areas), comment on the availability of affordable housing for

employees of businesses and industries that draw from the PMA.

7. A forecast of employment for the specified forecast period and how this forecast supports demand for additional new rental housing.
- F. Demographic Analysis. The market study must include a thorough description of the current and forecast demographic characteristics and conditions of the PMA and a comparison secondary market including a detailed explanation of all significant trends and changes.
1. Recent trends in population and household growth from the most recent decennial census, current estimates and growth projections over the next 5 years covering such subjects as population change, migration, net natural change, household growth or decline, changes in the average household size.
  2. For senior communities, current and projected senior household base with 55+ and/or 62+ householders.
  3. A thorough discussion of past building trends in comparison to household trends.
  4. Characteristics of the current household base, including family type, current and change in tenure, age distribution and household type and rent burden.
  5. Current income characteristics of the population and income by tenure.
  6. For senior communities, tenure breakdown, income characteristics and rent burden of senior households.
- G. Current Housing Market Conditions. The market study must include a comprehensive description of the current conditions of the rental market and of the sales market, in the PMA, if relevant. This description should include a summary statement on the current condition of the overall rental market and of the rent levels in the market of comparable projects, looking at both market rate communities and affordable units/communities. If appropriate to analyze, subsidized communities in which tenants are not responsible for all rent being charged should be discussed separately from market/affordable communities.

The analyses should include the following:

1. An estimate of the current competitive rental inventory of both single-family and multifamily units in the PMA, with data on the number of units by structure type, number of bedrooms, rent levels, year built and location.
2. A thorough discussion of recent market trends analyzing the following:
  - a. Current vacancy levels and recent trends in occupancy/vacancy in existing rental projects. Occupancy levels should be reported for market rate as well as affordable communities,

and/or age restricted communities, if applicable.

- b. Absorption experience of recently completed rental developments, including estimates at a project level of per unit per month absorption rates, with particular emphasis on comparable and competitive projects that have entered the market within the past 24 months.
- c. Current effective rents for comparable and competitive projects, reflecting incentives and utility policies. A discussion of rent trends in this inventory during the past 24 to 36 months. The description should identify any services included in base rents or offered at a premium. Where relevant, the report should include information on the extent of rent concessions or similar incentives, particularly in projects in initial occupancy and must address the impact of concessions on rent levels and whether the quoted rents are overstated due to concessions or other factors.
- d. Estimated current overall rental vacancy rate and vacancy rate for units similar to those in the proposed project. Significant seasonal variations in vacancy rates, if applicable, should be discussed.
- e. Discussion of any vacancy or absorption problems in the market, particularly in the segments of the market most relevant to the subject project.
- f. The impact, if any, of the single family and condominium market conditions, including an analysis of the cost to rent versus to own, and the impact of foreclosures and of the shadow inventory of single family and condominium units.

3. The report must include a map showing locations of existing competing rental projects, projects currently under construction, and those in the planning and development process.
4. If appropriate, analyze inventory, occupancy levels, and waiting list of deeply subsidized communities in the PMA.

H. Characteristics of Rental Units in the Pipeline, Under Construction and in Planning. The market study must include separate estimates of the numbers of rental units currently under construction and the numbers in the planning and development process likely to enter the housing market during the specified forecast period. These estimates should include all rental developments known, not solely those determined by the analyst to be comparable and competitive. The description of the pipeline activity should clearly identify any significant characteristics of specific developments with rent restrictions or rent limits such as LIHTC or age-restricted occupancy. The report should contain estimates of:

1. The number of projects currently under construction, the total number of units, the numbers by bedroom size (number of bedrooms) by rent range, structure type and amenities (if available).

2. The number of projects in planning stages that are likely to be developed, including but not limited to those with building permits or firm financial commitments, including details on the number of units by bedroom size, rents, locations, and stage of development.
3. A list of LIHTC projects in or near the market area that are not yet placed in service, giving as much known detail as possible on estimated placed-in-service dates, unit mix and income levels to be served.
4. For senior proposals, a list of all existing and anticipated senior projects within or near the market area, including characteristics such as type of age-restriction (55+ or 62+), number of units by bedroom size, income restrictions (if applicable), location, rents, and any features, amenities, etc. included with the rents. For future projects, as much known detail as possible on estimated placed-in-service dates should be included.
5. A map locating all proposed communities.

#### I. Demand Estimate and Analysis.

1. Net Demand Analysis: The market study must include an estimate of future demand for the specified forecast period, typically 36 months. The estimate of demand must be based on a calculation of incremental demand (i.e. demand for additional new units) and must address the following factors:
  - a. Renter household growth during the forecast period.
  - b. Recent trends in tenure broken down by homeownership and rental that may increase/decrease the demand for rental units. (e.g. households shifting from renter to owner tenure).
  - c. Replacement of existing rental units lost from the inventory due to demolition, conversion, shifting of owner units into the rental market and by other means.
  - d. The effect of any current excess vacant supply, based on an estimate of the balanced market vacancy rate.
  - e. The study must reconcile the number of units in the proposed project with the demand estimate for the PMA, taking into consideration current housing market conditions, available vacancy, and forecast additions to the supply (planned and under construction).
2. Effective Demand: The estimate of "effective demand" is the pool of households with sufficient incomes and/or applicable household size that would be expected to demand such housing during the forecast period, including the income levels and rent- to-income ratio(s) assumed in the study. Evaluation of Effective Demand includes an analysis of Capture Rate and Penetration Rate:

- a. Capture Rate is defined as the percentage of qualified households in the PMA that the property must capture to fill the units and achieve stabilized occupancy. Qualified Household is defined as households that meet any applicable age and household size restrictions and are within any limiting income eligible band such as LIHTC Income Limits and who have sufficient minimum income to pay the proposed rent without being rent overburdened, The Capture Rate is calculated by dividing the total number of units at the property by the total number of households that meet the applicable age and any income band requirements.
  - b. Penetration Rate is defined as the percentage of Qualified Households in the PMA that the property and similar existing and proposed competing properties must capture to fill all units and achieve stabilized occupancy. The Penetration Rate is calculated by dividing the total number of units in the competitive inventory (including the subject property and, current and proposed relevant competitive properties) by the total number of households that meet the applicable age and any income band requirements.
  - c. For subsidized communities, sensitivity affordability and penetration rate analyses should be conducted both with and without project based rental assistance.
3. The evaluation of Net Demand and Effective Demand should take into consideration:
- a. The current and anticipated supply/demand conditions in the overall rental market;
  - b. The potential depth of the market of income eligible households in comparison to the number of units at the proposed rents; and
  - c. The marketability of the proposed units taking into account the project's amenities, rents and location relative to comparable and competitive projects and other available housing options.
4. For LIHTC projects: Provide an estimate of demand, including capture and penetration rates, based on potential income-eligible residents. An income-eligible resident is one whose income does not exceed the maximum permitted by the affordability restrictions but who has sufficient minimum income to pay the proposed rent without being excessively rent-burdened. Note: households are considered "rent-burdened" if they are paying more than 30 percent of their household income in gross rent ("severely rent-burdened" if they pay more than 50 percent). The market study must describe what basis is used for rent-burdened: e.g., 30 percent, or some other percent, but in all cases less than 50 percent. To make these determinations, consider the following information and guidance:
- a. The market study should specify the applicable LIHTC maximum rents, markets rents, and impact on achievable rents and project-based subsidy rents.

- b. When the proposed rents are set at the LIHTC maximums, the market of income qualified residents for the restricted units is comprised of a relatively narrow band of income-eligible renters whose incomes do not exceed the maximum but are sufficiently high to pay the rent without being rent-burdened. This can result in problems with the market feasibility of the project. Depending on income and rental market conditions in the area, there may not be a sufficient number of potential renters who meet the income limit and are also able to afford the restricted rent. In many markets, LIHTC project rents need to be set below the maximum permitted.
- c. Some LIHTC projects include additional types of assistance (such as Section 8 rental assistance or various forms of subordinate financing) which further reduce the effective rents and thus expand the pool of potential income-eligible residents. The market study must identify the estimated number of households who are eligible but are not excessively rent-burdened when paying gross rent (including utilities).
- d. The determination of demand and capture/penetration rates should take into consideration:
  - i. the current and anticipated supply/demand conditions in the overall rental market,
  - ii. the potential depth of the market of income-eligible households in comparison to the number of units at the proposed rents, and
  - iii. the marketability of the proposed units taking into account the project's amenities, rents and location relative to comparable and competitive projects and other available housing options.

The Regional Center/Satellite office staff should consult with EMAD in assessing the determination of eligible income band, capture rate and absorption rate contained in the market study. Projects with insufficient demand for the units at the proposed rents should be rejected.

## J. Findings and Conclusions.

1. Project Evaluation: Evaluate the subject property within the context of the site, economic, demographic and competitive characteristics. Comment on the strengths and weaknesses of the proposed project in terms of location, project size, unit breakdown, unit sizes, amenities, features and rents.
2. The absorption rate is defined as a projection of the pace of unit lease up as units become available for occupancy. The study should also include an estimate of the absorption period needed for the project to reach sustaining occupancy based on current market data and the *quantitative and qualitative demand* estimates.
3. The market study must include an assessment of the impact the proposed project will have on existing rental developments. Specifically, the study must address the impact on existing insured properties and show if sufficient demand will be derived from new renter households, the shifting of households into the rental market, or the replacement of lost or sub-standard units. It must be demonstrated quantitatively that the number of units under construction and the proposed supply, including the subject, will not create over-supplied or overall soft market

conditions. Even if the subject does not directly compete with existing insured or uninsured properties, an oversupply of units could spill over into all segments of the market.

4. For age restricted properties, the market analyst must describe the intended occupancy regime. The MAP Lender's underwriter narrative must ensure that the analysis and owner's intent based on their representations comply with FHA program guidance and Fair Housing law.

K. **Additional Requirements/Guidance for Income Restricted Projects.** According to USPAP Advisory Opinion 14:

“Subsidized housing may be defined as single- or multifamily residential real estate targeted for ownership or occupancy by low- or moderate-income households as a result of public programs and other financial tools that assist or subsidize the developer, purchaser, or resident in exchange for restrictions on use and occupancy.” While HUD provides the primary definition of income and asset eligibility standards for low- and moderate-income households, other federal, state and local agencies define income eligibility standards for specific programs and developments under their jurisdictions.

The competency required of appraisers and market analysts to appraise or prepare market studies for subsidized housing extends beyond typical multifamily residential experience and requires an understanding of the various programs and definitions involved in the particular subsidy program applicable to the development. Practitioners should be capable of analyzing the impact of a particular subsidy program in both the general market and the local subsidized housing submarket. Political changes may affect these requirements and therefore must be fully understood.

- L. **Data, Estimates, and Forecast.** The study should document the methods and techniques used to develop all estimates and forecasts and provide relevant and current citations on the sources of all data, estimates and forecasts. Conclusions in the study must be consistent with the facts presented; findings and recommendations should be based on a reasonable forecast of market supply/demand conditions and sound assumptions regarding capture rates, absorption, achievable rents, income affordability and similar factors. To the extent possible, the qualitative and quantitative estimates of demand for additional rental units should take into account the changes in renter households by household size, not just in total. Although data for all household sizes may be used, a study of the trend of change by household size may derive a more representative and accurate demand estimate consistent with the characteristics of the target market.

## **7.6 Appraisal Requirements**

- A. The Development of the appraisal must comply with USPAP Standards Rule 1, the Scope of Work Rule and assignment conditions outlined throughout this guidebook. The report shall be in a narrative format, comply with USPAP Standards Rule 2, and contain all of the information necessary for loan

underwriting and for the reviewer to easily understand the reasoning employed by the appraiser. Standard Rule 2 does not dictate the form, format, or style of real property appraisal reports. The form, format, and style of a report are functions of the needs of the client and intended users. The substantive content of a report determines its compliance.

- B. **Effective Date.** For pre-applications, all appraisals must have an effective date within 120 calendar days before the date of the pre-application package. For Firm Commitments, the effective date of the appraisal must be within 180 calendar days prior to the issuance of the Firm Commitment. The MF Regional Center/Satellite Office may require an updated appraisal prior to an amendment, re-issuance or an extension of the Firm Commitment, e.g., if there is a material change in the terms of the mortgage or in the market conditions and market data upon which the Firm Commitment was based. Expired reports may be amended or updated as needed by re-surveying all relevant data. HUD defines the effective date as the most current date that the appraiser inspected the subject, and comparables and developed estimates of rents and expenses. Updated appraisals can be submitted if the appraiser re-inspects the exterior of the subject project, re-surveys the rental comparables, and reviews the market for any additional sales comparables. USPAP Advisory Opinion 3 should be followed for guidance on completing and reporting appraisal updates. Lenders should provide for updates in their response to the invitation letter in case of processing delays prior to issuance of the Firm Commitment. The Regional Center/Satellite Office has the authority to waive the 180 day requirement or decrease the amount of time until expiration of the report depending on market conditions.

The Department recognizes that occasionally there may be situations where the Inspection Date and Effective Date may differ but there should not be a significant difference between the Inspection Date and the Effective Date. While in the course of preparing the appraisal report, new market information may become available that has a material effect on the results of the appraisal. This should be noted in the appraisal report. If there are questions, the Regional/Satellite Office (not HQ) should be consulted.

- C. **Brevity.** The appraisal report should be clear and concise. The appraiser should reference in the body of the report conclusions derived by the analysis of large tables of data and the actual data should be included as an addendum. Verbatim quotations of large portions of published national and regional reports should be avoided. Appraisals must be submitted as a searchable PDF file with one signed hard copy.
- D. **Complex or Unusual Appraisal Assignments.** When an appraisal assignment involves a subject with property rights issues or other unusual circumstances, third party appraisers must be sure to comply with USPAP Standards Rule 1-1(a), "In developing a real property appraisal, an appraiser must be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal." When these issues occur, the lender and appraiser (if identified) should consult with the Regional Center/Satellite Office at a concept meeting before appraisal assignment begins.

- E. Form HUD-92264 and supporting forms HUD-92273, HUD-92274, and HUD-92264T (if applicable) must also be prepared and included in the report.
- F. The USPAP Jurisdictional Exception rule is not generally applicable in HUD appraisal assignments. Nevertheless, the USPAP Jurisdictional Exception Rule clearly states that if an applicable law precludes compliance with any part of USPAP, then that part of USPAP becomes void for that assignment, including administrative rules such as the MAP Guide and HUD Notices.
- G. **Occupancy Percentage.** Unless otherwise noted, the occupancy used in the valuation of properties for acquisition or refinance should be based on the occupancy that is prevalent for the subject's area. This is reflected in Criterion 3 on the form HUD 92264-A. The underwriters may need to use more conservative (lower occupancy/higher vacancy) rates to comply with FHA program guidance in sizing the debt service constrained mortgage comparisons. The estimate of occupancy should take into account the historical performance of the subject and the vacancy and collection loss typical for the subject's market area to determine the occupancy percentage. The appraiser should ignore unsustainable market conditions and short-term spikes in the occupancy rate due to seasonal changes and short-term demand for specialized employment, e.g. disaster relief workers.
- H. Sections 220, 221(d), and 231 (new construction only) do not call for an "as complete" value conclusion. The Department considers valuation work for these assignments to be an appraisal that is developed and reported in compliance with USPAP Standards 1 and 2.
1. By statute, FHA Multifamily new construction programs are replacement cost limited mortgages and require a valuation of the land, a debt service analysis and a cost approach to value. An estimate of the market value after completion is not required or relevant. The appraiser must fully examine the proposed construction costs of the subject project. The map lender's Appraiser must present analyze and support the cost approach based on the plans, specifications and development costs using either a subscription cost service such as Marshall & Swift, the lender's third party cost analyst or a direct comparative analysis of recently completed similar developments. Substantial Rehabilitation projects require an estimate of the "As Is" value of the project (as opposed to only the land) by use of the income and direct sales comparison approaches to value when possible. Unoccupied or "shell" structures may be appraised using the sales comparison approach and/or cost approach.

**NOTE:** The Section 231 Sub Rehab Program is an exception – those projects require both a cost and "as repaired" value limit mortgage.

For apartments that are occupied, the primary method to determining value is the Income Approach. The value should be what the typical purchaser would pay for the income stream currently associated with the subject on its actual condition, occupancy and considering rent restrictions. The as-is value must not be based on after rehab projected income or any advantages that will accrue as a part of the transaction.

**NOTE:** See special instructions for Cost Certification as it relates to As Is Valuation in Chapter

13.21.

2. Exhibits. The appraiser and the MAP Underwriter must assure that there is sufficient narrative and exhibits to allow a reliable underwriting decision to be reached. This should include, but is not limited to, location maps, photographs of the subject, rent and expense comparables, site and floor plans, along with thorough explanations of all adjustments.
- I. For Section 223(f), apply all three approaches to value for subjects that have an actual age of less than ten years. The appraisal for the 223(f) refinancing should assume market value for purposes of developing Criterion 3, and should further assume that any proposed repairs/improvements have been completed, as rents, expenses and value must reflect completion of any proposed repairs or improvements. Not all repairs/improvements will result in an increase in value. Structural repairs, utility line improvements or other repairs that do not directly result in an increase in market share or would not result in a resident's willingness to pay an increased rental amount will likely not increase value. Any proposed rental increase must be demonstrated by market data.
1. Cost/ Summation Approach. The cost or summation approach must consider all applicable forms of depreciation, functional and external obsolescence. The cost/summation approach shall not automatically set the upper limit of value for these programs. The appraiser should provide a final reconciliation of the three approaches to value, and consider the basic principle of substitution in that no prudent purchaser would pay more for a project than the cost to acquire a similar site and construct improvements of equal desirability and utility. This approach may be eliminated at the discretion of the appraiser for subjects that are ten or more years old.
  2. Sales Comparison Approach. In multifamily housing, the entire project as a whole typically does not offer a convenient basis for comparison with other entire projects due to differences in size, composition, areas, units and rooms. In such cases, acceptable units of comparison are price per living unit, price per room, and price per square foot of gross building area (GBA). Appropriate adjustments should be made and justified.
  3. Income Approach. The annual net operating income (NOI) remaining after the payment of expenses is considered to be the primary source of value to the project. The preferred method of capitalizing the NOI into a value estimate is Direct Capitalization. There are several acceptable techniques for deriving capitalization rates. Rate Extraction based on recent (preferably within the past year) comparable sales is the most preferred. Band of Investment should be considered and may be acceptable. The appraisal should also contain discussion of how the chosen capitalization rate compares to rates listed in published reports such as Price Waterhouse Cooper [realtyrates.com](http://realtyrates.com), etc. Discounted Cash Flow Analysis may be used only in certain situations involving leaseholds. See Chapter 7.16.

The Capitalization Rate must be based on factors reflecting the overall demands of knowledgeable investors in properties similar to the subject. Regardless of the method used in deriving the rate; it must be supported by current market information, i.e. recent sales, typical loan terms and return on owner's equity. The Capitalization Rate developed and applied by the appraiser must reflect actual investment expectations as of the appraisal date. The appraiser must report all market comparables used to derive the Capitalization Rate.

Underwriters may need to adjust the rate used in securing the mortgage so land values reflect FHA program requirements but should not adjust the appraisal or the appraiser's value conclusion. For example FHA does not permit a Capitalization Rate lower than the mortgage debt service constant. Similarly, the underwriter may need to use a more conservative valuation to reflect the disparity between a temporary but unsustainable "heated" market over the long term amortization of an FHA insured loan.

All three approaches must be internally consistent in order to achieve a reliable estimate of market value.

- J. For Section 231 Substantial Rehabilitation cases, follow the instructions for Section 223(f). Substantial rehabilitation under Section 231 differs from Sections 220 and 221(d)(4) in that a market value based on the completion of the rehabilitation is required.
- K. Remaining Economic Life (REL). HUD Multifamily Housing programs allow for long term amortization periods. Accordingly the HUD Underwriter must determine the REL and the remaining useful/physical life based on review and reconciliation of the appraisal, CNA, recommendations from the appraisal review, and their own observation. This estimate is not a strictly formulaic calculation. REL is defined as the estimated period during which improvements will continue to contribute to project value and an estimate of the number of years remaining in the economic life of the structure or structural components as of the date of the appraisal. For new construction and substantial rehabilitation projects, the maximum mortgage term is the lesser of 40 years, or 75 percent of the REL. For existing properties, the maximum mortgage term is the lesser of 35 years, or 75 percent of the REL.

When used in this section, the words and terms below are defined as follows:

1. Physical Life. The period from the time of completion (as new or after substantial rehabilitation) of a structure until it is no longer fit or safe for use or when maintaining the building in a safe, usable manner is no longer practicable. Because a building is subject to physical deterioration and obsolescence, its period of usefulness is limited. As a building deteriorates or becomes obsolete, its ability to serve useful purposes decreases and eventually ends. This may occur gradually or rapidly.
2. Economic Life. The period over which improvements to real property contribute to property value. Economic life can never be longer than the physical life, but may be shorter. Both Physical and Economic life will be affected by the underlying construction quality, market incentives, level of maintenance/updating to correct physical deterioration and/or functional obsolescence.

3. **Functional Obsolescence.** Reduction in the usefulness or desirability of the improvements to real property due to the presence of outmoded features such as lack of closet space or the number of bathrooms commensurate with the number of bedrooms. Such features are often not curable and may or may not be relevant in evaluating the REL.
4. **Effective Age.** The apparent age of the improvements to the real property, which may vary from its actual or chronological age. The effective age is determined by the appraiser assuming the required repairs to be made as specified in the CNA as a condition of refinancing and based on the following factors:
  - a. Workmanship, durability of construction and the rate with which natural forces cause physical deterioration;
  - b. The physical condition and probable cost of maintenance and repair, the maintenance policy of owners and occupants and the use or abuse to which structures are subjected;
  - c. The economic background of the community or region and the need for accommodations of the type represented;  
**NOTE:** racial, ethnic or other demographic characteristics of Fair Housing Act protected classes may never be taken into account when conducting an appraisal.
  - d. The relationship between the property and the immediate environment, the architectural design, style and utility from a functional point of view and the likelihood of obsolescence at attributable to new inventions, new materials and changes in tastes;
  - e. The trends and rate of change of characteristics of the neighborhood and their effect on land values.
5. **Remaining Economic Life (REL).** REL is the Economic Life less the Effective Age. The effective age is determined by the appraiser based on the actual condition of the subject considering all applicable forms of depreciation. The appraiser should assume the required repairs to be made as specified in the CNA as a condition of refinancing and consider the type and quality of construction, maintenance factors, and any other relevant market and economic factors that might influence the long term success of the project.

Examples that illustrate the implementation of these concepts:

***An older structure with functional obsolescence remains competitive in an area that is dominated by modern apartment projects commanding higher rents.***

Such structure could be a market rate project in a particularly desirable location, or a former public housing project. The MAP appraiser's market analysis indicates that there is a lower income population in the market area that will likely allow the project to remain competitive for a long term. This can cause the effective age to be lower, with a commensurate increase in REL.

*A structure that is sound and in good physical condition with many years of physical life remaining may have reached the end of its economic life - if its remaining years of physical usefulness will not be profitable.*

Apartment projects in a given market area have either been severely damaged or destroyed by a hurricane. Most of these properties are either being replaced by new structures or are receiving substantial renovation that will include correction of functional obsolescence. This could result in a lower effective age with a corresponding increase in REL.

- L. HUD is the regulatory enforcement agency identified in the Confidentiality Rule of USPAP. Appraisers will be required to present their entire work file and fully disclose the identity and source of confidential information should the Department determine a review of the appraiser's work file is in order. (Note that, per USPAP, disclosure to enforcement agencies does not constitute a violation of the Confidentiality Rule.) The appraisal must be prepared with the list of information contained in Appendix 4.
- M. Include an appraiser's Certification with the format in Chapter 11 as well as the most current USPAP certification.
- N. Inspection of the Subject and Comparables. The primary appraiser designated by the lender and accepted by HUD must physically inspect the subject (both exterior and interior) and all of the comparables used as part of the analysis. The primary appraiser must also sign the Certification within the appraisal report and the supporting HUD forms.
  - a. The primary appraiser must inspect at least one of each bedroom/unit type. The total number of units inspected must equal or exceed 5% of the total number of units for projects of up to 200-units, or 4% of the total number of units for projects greater than 200-units. If the characteristics and/or condition of the subject indicate that a higher level of inspection is necessary, it is the appraiser's responsibility to expand the scope of the work may be necessitated by the observations made by the primary appraiser during the inspection of the subject. This is especially important where the improvements are high-rise structures and individual units within the building demonstrate varying degrees of light and view qualities. If there are hazardous conditions or other factors that preclude a thorough inspection of the interior, the appraiser must clearly indicate these circumstances in the appraisal report.
  - b. For large projects exceeding 500 units, the lender may permit a lesser percentage but reasonable number of units to be inspected by the appraiser. In addition, the appraiser may employ assistants to inspect individual units so as to encourage a thorough inspection. The names and qualifications

of these assistants must be disclosed in the appraisal report. The assistants are not required to sign the report.

- c. The primary appraiser must inspect all of the comparables used in deriving and estimate of value, including land comparables (if applicable), improved comparables sales, expense comparables and rental comparables. The appraiser must verify the condition of the comparables with management or other personnel familiar with the project whose contact information must be documented in the appraisal report.
  
- O. Required Appraisal Report Exhibits. Photographs (subject, and all comparables including rentals), regional map, location map, satellite scans (if available from Google, Bing, etc.), flood hazard map, survey (if available), floor plans (for each type of unit being offered - if available), site plan, zoning map, tax map, land sales comparable map, rental comparable map, and improved sales comparable map are required with all submissions.
  
- P. Market Analysis Requirements for Multifamily Appraisals. The appraisal must also contain, depending on the complexity of the project and prevailing market conditions, a Level B or C Market Analysis of the local market with an emphasis on multifamily housing so as to determine the ability of an existing project to continue usage as multifamily housing. In the case of proposed construction or substantial rehabilitation, the purpose is to determine overall feasibility and demand for new housing units. A brief outline of a Level C analysis follows:
  - a. Location. This includes a general description, specific analyses of site linkages and urban growth determinants and detailed competitive location rating.
  - b. Demand Analysis. This includes a discussion of general evidence of sales/leasing activity, general city/area growth trends, market absorption, demand and need forecast based on population, employment and income and a demand forecast of the subject market segment.
  - c. Competitive Supply Analysis. This includes vacancy rates for comparables and from market surveys (secondary data), field research on all competitive and proposed properties, building permit analysis, identification of proposed sites, and a detailed competitive amenities rating.

The detailed requirements for performing a Level B or C analysis can be found in “Market Analysis for Real Estate”, published by the Appraisal Institute. In general, a stable market evidenced by a recent sales, and balanced supply and demand is an indication that a lower level “B” analysis will be sufficient. If there is uncertainty in determining the level of analysis, the lender and appraiser should jointly consult with the Regional Center or Satellite Office.

## 7.7 Estimating Project Income

- A. Rental estimates.** The appraiser must estimate the annual gross income of the subject project including estimates of income from market comparables, rental concessions, and an assessment of the general health of the rental market. The gross income estimate assumes a full occupancy level and reflects rent levels current as of the appraisal date or date of the market study. Also, consider the effect that any proposed repairs to the project will have on rents, expenses, and net income; however not all repairs will increase rents, occupancy, net income, and/or decrease expenses.

Rent comparables. Market rent by comparison shall be estimated by the appraiser and documented on the Form HUD-92273 or Form HUD-92273-S8 if the appraisal is also being used as a Rent Comparability Study (RCS). A separate Form HUD-92273 is to be prepared for each type and size of rental unit in the subject project (if significantly different).

Market rents attributed to the subject property should not be speculative. If rents are based on levels achievable assuming that proposed repairs are completed, then those units that have had repairs completed and are leased are most reflective of market or near market rent levels. The rent comparables and units selected for comparison must be as similar as possible to the subject project and units as to location, structural type, number of bedrooms, and average unit size. In order to ensure they are truly comparable and competitive with the subject project, appraisers should generally not use rent comparables located outside of the subject's market area, but should be from areas similar to the subject and should be fully explained in the report. Market rate units from partially assisted projects can be used as rental comparables in the absence of better rental data.

- B. Adjustments.** Consistent adjustments for significant differences between the comparables and the subject units shall be derived from the market and applied to the subject rent estimate and fully explained. Rental adjustments are always made to the comparables reflecting differences with the subject project.
- C.** The appraiser should select the final rent estimate based on the comparables that are the most similar to the subject in location, size, style and desirability. In situations where the appraiser gives the greatest weight to the highest or lowest comparables, the appraiser must explain and substantiate with market data why the chosen comparables are the most reliable. Often the best comparables are those that require the least amount of adjustment. Just as the most appropriate rent comparable must receive more weight, the general health of the rental market must be recognized before relying upon one or two optimistic indicators.
- D.** On LIHTC and/or bond financed projects, the Form HUD-92264T must be completed to determine the appropriate processing rents.
- E. Trending of Rents.** Rental estimates shall be made as of the appraisal or market study date and may not be trended to a future date. Since rent estimates are made based on street rents currently being obtained by the comparables, no time adjustment is needed for an estimate as of the appraisal or market study date. Estimate GPI based on in-place rents at the subject property as evidenced by current rent rolls.

- F. Equipment included in Rent.** Equipment included in the subject rent such as ranges, refrigerators, microwave ovens, air conditioning equipment and laundry facilities must be identified. Services included in the subject rent frequently include heat, air conditioning, water, and trash removal, and must also be identified. Comparable project equipment and services must correspond to the same items of equipment and services provided in the subject proposal and the adjustment process must reconcile any differences. This analysis also applies to the analysis of expenses.
- G. Occupancy/Vacancy and Collection Losses for Residential Units.** The appraiser must establish a factor for vacancy and collection loss when determining the effective gross annual income for the residential units. The factor must consider both historical and current data (applicable for existing properties) of the subject project, the rental comparables and any anticipated changes in the market. The factor selected must reflect long-term occupancy rates that are expected to continue. The estimate of occupancy should be based on the actual occupancy of the subject without regard to programmatic constraints imposed on the maximum underwritten occupancy when calculating debt service coverage. The estimate of occupancy should take into account the vacancy and collection loss typical for the subject's market area and, if applicable, be consistent with the subject's historical performance.

In all cases the appraiser should use income from actual operations and market conditions in determining value. In sizing the loan for purposes of debt service, the underwritten vacancy rates will be the greater of the minimums below and actual levels, however these minimums may be used to develop market value if deemed appropriate by the appraiser.

<i>Minimum Vacancy and Collection Loss Rate</i>	<i>Property Type</i>
3%	<ul style="list-style-type: none"> <li>• Properties with HAP contracts covering 90% or more of the units; <u>or</u></li> <li>• In-place rehab with</li> <li>• Occupancy at or above 90%, and</li> <li>• 90% or more of the units set aside as LIHTC units, and</li> <li>• Attainable Tax Credit rents at least 10% below market (i.e. a “discount” to market).</li> </ul>
5%	<ul style="list-style-type: none"> <li>• Properties with 80% or more of the units set aside as LIHTC units, and</li> <li>• Attainable tax credit rents at a 10% discount to market.</li> </ul>
7%	<ul style="list-style-type: none"> <li>• LIHTC properties with any percentage of units set aside but without a 10% discount to market; or</li> <li>• Properties in which 20% or more of the units are Market Rate.</li> </ul>

**H. Project Rent Concessions.** Rent concessions in comparable projects must be included in the analysis and an appropriate adjustment made to the subject rent based on the comparable units. The adjustments must reflect the actual impact on gross annual income resulting from the comparable rental concession.

**I. Occupancy.** When the occupancy rate in a comparable project is significantly less than the long-term occupancy rate estimated for the subject, a downward adjustment should be made to the comparable’ s rent. If other factors such as condition have had an effect on occupancy, care should be taken to avoid excessive and duplicative adjustments for interdependent factors. The appraiser must note the actual market derived commercial vacancy/occupancy rate in the appraisal report. However, the appraised value of the commercial space component for acquisition/ refinance or the underwritten net operating income (NOI) for new construction/substantial rehabilitation projects must assume either the lesser of what is indicated by market or the occupancy limitations of the specific program.

**J. Utilities/Services.** All of the items for consideration under this heading refer to the cost of the services of water, sewer, gas and electricity that may be included in the rent. In some cases, even though both the subject and the comparable units have the same service included in the rent, an adjustment may still be warranted to bring the comparable in line with the subject, due to size, equipment, utility rate, type of

utility, etc. If included in the comparable rent, but not in the subject, enter a negative adjustment reflecting that portion of the comparables rent attributable to the inclusion of the service. If excluded from the comparable rent, but included in the subject rent, enter a positive adjustment reflecting the estimated increase in rental value attributable to including the service in the subject's rent.

**K. Project Location, Amenities and Other Factors** Consider the subject location relative to distance from shopping, recreational, social, and medical and employment centers, neighborhood desirability, transportation, special hazards and nuisances.

1. "Other" items that may be considered include but are not limited to, the following:
  - a. Livability—reflect good or poor unit design and configuration, including room sizes, layout adequacy of closets, lighting, elevators and laundry facilities, etc.
  - b. Condition of improvements—reflect lack of maintenance, soundproofing, etc.
  - c. Parking—reflect parking rates, adequacy of parking for visitors, proximity of parking to the units, inclusion/exclusion of parking space with unit rental, etc.
  - d. Project density—consider open space or crowding of units, if the degree of either is such that it would affect the level of attainable rental.
  - e. Unit location—reflect features of location of a unit within the project, such as view, proximity to swimming pool, tennis or other recreational facility, and/or other similar factors.
2. Generally, only high-rise elevator comparables are to be compared with the subject elevator high-rise proposal. Mid-floor level rents of the comparables are compared with the mid-floor level of the subject project. Adjustments for heights of the comparables above and below the mid-floor level of the subject also must be made, as indicated by the market.

**L. Other Income.**

1. **Ancillary Income.** The appraiser may consider other income based upon the operating history of the project and whether these sources of income are common in the market. Other income might include but is not limited to recurring and reliable sources such as laundry facilities, parking, equipment rental, vending machines, and cable fees. The appraiser can consider the net amount of this other income based on the actual or projected (as appropriate) amount received, adjusted for vacancy and income loss. The analysis must be discussed in the Remarks Section of Form HUD-92264.
2. **Short-Term Lease Premiums.** Projects with lease terms that are less than 30 days are not eligible for HUD-insured financing under any circumstances. Income from other short-term leases may be considered to the extent that it exists in the local market. There must be a thorough discussion of the prevalence of short-term leases in both the appraisal and underwriting summary. The amount of the premium is the difference between the rent for a unit with a term that is typical for the market (generally one year) and the rent for a short term lease. This premium is resident-related and is treated as ancillary income. Units with short term leases do not require a separate Form HUD-92273, but the rental amount must be based on market information.

3. Corporate Leases. Corporations and businesses are eligible residential residents in insured projects, so long as the lease term exceeds 30 days although compliance with the policy on Short-Term Lease Premiums is required and the number of units subject to the leases does not exceed 10% of the units. For underwriting and valuation purposes, the percentage of total gross income obtained from corporate leases shall not exceed 10%.
4. Pool, Pet Fees/Rent. These fees may be recognized based on operating history and prevailing market conditions. For existing projects (223(f) and occupied substantial rehabilitation) the greatest weight should be given to operating history. For new construction cases, any projected income from these fees must be supported by hard data and a thorough discussion of competing and comparable properties.
5. Ineligible Income. Ineligible income should be noted and discussed in both the narrative appraisal report and the remarks section of the Form HUD-92264. There is no prohibition on this category of income but it cannot be included in the income calculation for the purposes of determining value or the maximum insurable mortgage. Ineligible income includes the following:
  - a. Interest Income. The appraiser must not include in the calculation of income any interest income, including interest on reserves.
  - b. Ineligible Fee Income. Non-recurring and non-regular income that is not reliable may not be included in the calculation of income. Examples may include, but are not limited to forfeited security deposits or forfeited rent. Reliance on a forfeited security deposit or forfeited rent may be common due to management practices in a project or market, but will not be recognized by HUD/ FHA on either the valuation or underwriting.
  - c. Furnished Units. Furnished units must be underwritten at the same rental rate as unfurnished units. This applies to all units, including those having corporate and short-term leases. For valuation purposes, furnished units can be valued based on the prevailing market conditions.
  - d. Non-Shelter Services/Elderly Developments. Refer to Section 3.1.O.5.
6. Commercial Income. Where commercial facilities are included in a mixed-use project, a separate analysis must be made of the effect that the commercial operation will have on the project. The appraiser must calculate income, vacancy and collection loss, operating expenses, and replacement reserves attributable to commercial space separately from the residential space. Project paid resident improvements must be accounted for as a leasing expense, and if applicable, a separate commercial-space operating deficit must be calculated in addition to the required residential operating deficit.
7. The term "Commercial" is applied to any space or facility permitted and acceptable for "Nonresidential Use" from which income is derived or anticipated. Income from residents for the use of facilities such as community rooms and parking are not considered commercial even though fees may be collected. This income is considered ancillary income and is treated separately from commercial income. However, income from non-residents related to parking or other community facilities must be treated as commercial income and is subject to the restrictions on the underwritten occupancy rate as noted in Chapter 3.

8. The space occupied by parking and community facilities is not included in the calculation for allowable commercial space. Non-tenant parking income from commercial parking spaces reserved for use by motorists who are not project residents or are not parking to use the on-site commercial tenant’s facilities must be included in the Commercial Space and Income limitations. The income and space attributable to parking spaces reserved for non-residential or non-commercial tenants must be included in the limitations, based on applying the percentage of the total spaces that are reserved for non-tenant use. For existing properties that provide parking for a monthly fee and are to be acquired, refinanced or will undergo substantial rehabilitation, the lender must identify the percentage of monthly parkers who are non-tenants so as to include these in the commercial income limitations. The maximum occupancy factor to be applied to the parking income attributable to parkers who are not associated with either the project’s residential or commercial tenants shall be the lower of:
- a. The amount indicated by the market and by the historic performance of the subject; or
  - b. 50 percent.

**NOTE:** For proposed construction, or where new commercial parking facilities are to be constructed, the demand for this parking must be addressed in the market study, appraisal and underwriter’s narrative.

If the borrower operates a parking facility that provides parking for residential or commercial tenants of the project, the lender must determine underwritten parking income based on an analysis of the past 3 years of operation and the trailing 12 month period prior to application.

If the parking facility is operated by a third-party, the lender may use the amount of income collected under the contract if it is a fixed monthly payment. Parking contracts that specify a percentage rent in addition to or in place of a fixed rent are not permitted without a waiver.

A separate analysis must be performed for each type of space using the Form HUD-92273 or a similar format to summarize appropriate adjustments to comparable data. These studies can be incorporated as a separate section in the overall residential market study submitted at the pre-application or firm stages, depending on the program requirements, and must also comply with Appendix 7A. Care must be taken in reviewing the allowable square footage and income percentage attributable to the commercial/office space since these requirements vary by program. See table below:

<b>Commercial Space and Income Limitations</b>		
<b>SOA</b>	<b>Maximum Percentage of Rentable Area</b>	<b>Allowable of Total Net Maximum Percentage of Effective Gross Income</b>
221(d)(4) and 231	25%	15%
220	25%	30%
223(f)	25%	20%

For all programs except Section 223(f), the maximum underwritten commercial occupancy rate shall be the lesser of: a) that indicated by the market, or b) 80 percent. For Section 223(f), the

maximum underwritten commercial occupancy rate shall be the lesser of: a) that indicated by the market, b) the actual occupancy rate of the subject, or c) 90 percent. For special instructions related to the maximum underwritten occupancy rate for non-tenant parking income see Section 7.7.M.2.

#### **M. Limited Waiver of Commercial Income and Space Limits.**

1. **Commercial Income Limits.** Regional Center Directors may issue waivers of the commercial income limits in Section III B, above, so long as the amount does not reflect a property that is primarily commercial rather than residential. Commercial income for NC or SR programs greater than 20% of the effective income should use the 220 program rather than a waiver of the 221(d)(4) limit. The Regional Center Director's approval must document that the project's commercial component will contribute to meeting the Department's Strategic Plan Goals, including promoting sustainable communities or supporting transit-oriented development. If the lender requests a waiver of the commercial income limits, HUD may require that the request be supplemented by a complete credit analysis of all existing or pre-leased commercial tenants. Waivers may be granted where there are clear mitigating circumstances that justify such a waiver. Examples include but are not limited to:
  - a. A long-term lease with a credit-worthy tenant, such as a government agency or a large, well-established corporation;
  - b. A multi-tenant commercial space where most of the tenants have a long history of occupancy (5 or more years) and full occupancy of this space is not needed to provide a break-even cash flow for the project; or
  - c. There is substantial borrower equity and/or local government funds that mitigate risk.
2. **Commercial Space Limits.** Regional Center Directors may issue waivers to exceed the commercial space limits in Section III B, above. In order to justify a request to waive the commercial space limitation, the owner must demonstrate:
  - a. that the additional space will not negatively impact on the use of the project by its residential tenants and will not create a nuisance to the surrounding community, so as to create a situation where the project is no longer residential in nature;
  - b. there is ample market support to assure occupancy of the space within the projected absorption period; and
  - c. any issues involving easements, liability insurance, parking and zoning must be resolved prior to granting the waiver.

N. Unlike the valuation of the residential portion of a mixed use project, the appraiser must value the commercial portion of the project, by applying the programmatic income and space limitations used to establish the commercial NOI for calculating debt service coverage (see Chapter 3).

1. The appraiser must: Conduct a complete analysis of at least three commercial income and expense comparables and provide a photograph, the resident's name, type and address of business, square feet, rent, vacancy, any concessions and major lease terms for each comparable.
2. Provide data to support the subject's commercial vacancy rate in relation to the market commercial vacancy rate and review the rollover risk and cost of resident improvements to re-lease space. Use a vacancy factor of not less than 10% for Section 223(f) and 20% for Section 221(d) and Section 220 new construction or substantial rehabilitation to obtain effective gross commercial income for underwriting purposes.
3. Provide the term, commencement date, expiration date, and name of the resident, square footage, and calculation of gross rents, expenses, reimbursement of expenses, cancellation clauses, and renewal clauses for each lease.
4. The project expense estimate must include all commercial expenses payable by the project owner. The analysis of all commercial income and expenses must be reflected on Form HUD-92264 with all the supporting data attached to the form. The expense estimate must include all commercial expenses payable by the owner. The analysis of all commercial income and expenses must be reflected on Form HUD-92264 with all the supporting data attached to the form.

## **7.8 Operating Expense Estimates and Underwritten Net Operating Income (NOI)**

A. Purpose. The appraiser shall determine the costs to maintain, operate and repair the project and to defray the costs of ownership. An accurate analysis of operating expenses is essential to determining a realistic net income estimate.

Appraisers must use either the form Form HUD-92274, Operating Expense Analysis Worksheet, or an alternate format to develop project expense estimates to be included in for Section E of Form HUD-92264, Project Income Analysis and Appraisal. If an alternate format is used (e.g. to trend by line item), to be consistent with the expense treatment on the HUD-92264, it must contain the same level of detail as the Form HUD-92274. Form HUD-92274 will be prepared for all cases and must be included in the processing file as supporting documentation for Form HUD-92264.

Market expenses attributed to the subject should not be speculative and should bear some reasonable relationship to the project operating history, understanding that some savings in operating expense line items may be gained when proposed repairs are completed. An example of savings might be reduced

utility expenses based on the installation of certain energy-efficient features. Reduced real estate taxes based on a new assessment classification would also be justification for estimating operating expenses lower than indicated by the project-specific operating history.

## B. Sources of Expense Data.

1. For new construction projects, operating expenses must be estimated on the basis of comparable projects.
2. For existing projects, for both valuation and debt service, operating expenses must be adjusted on the basis of comparable projects, but will primarily be based on the past 3 years of operating experience for the subject project. In addition, the lenders should provide trailing 12 months of income and expenses for the appraiser to compare to the historical statements.
  - a. The most current year project financial statement must have a third party CPA or IPA review. Owner certified financial statements may be submitted for the years prior to the last full Fiscal Year. Any owner-certified financial statement or owner-certified balance sheet and operating statement must include the following acknowledgment:

“WARNING: 18 U.S.C. 1001 provides, among other things, that whoever knowingly and willingly makes or uses a document or writing containing any false, fictitious, or fraudulent statement or entry, in any matter within jurisdiction of any department or agency of the United States, shall be fined not more than \$10,000 or imprisoned for not more than five years, or both.”

- b. Exceptions. For refinance transactions where the project may not have been under the current ownership for the 3-year period, financial statements for the entire 3 years may not be available. This is particularly true for bankruptcies or the acquisition of defaulted properties. Also, in purchase transactions, not all the required information may be available for reasons beyond the purchaser’s control. In these situations:
      - i. The borrower must submit a statement through the lender that explains why all the required records cannot be obtained.
      - ii. The lender must also certify that they have evaluated the borrower’s statement and agree that the information is not available.

The Regional Center Director may waive the requirement for past 3-year period financial statements. However, the borrower must submit the project financial statements that are available including an owner-certified year-to-date balance sheet and operating statement.

3. All projects must be analyzed as independent operations and must not reflect shared expenses from nearby projects under the same management, including shared insurance premiums. If the nearby project should be subject to foreclosure, the subject project would be adversely affected, thereby constituting an unacceptable underwriting risk. For the same reason, estimated expenses must

reflect typical long-term operation and must not reflect a specific sponsor or management entity whose operation would not be typical.

- C. General: Operating expenses are periodic expenses needed to maintain the project and to continue the production of effective gross income. For appraisal purposes, an operating statement that conforms to the above definition of operating expenses may differ from statements prepared for accounting purposes. Current or historic statements must be prepared on a cash basis. It is important to verify the accounting basis for the operating statement, since project operating expenses for appraisal purposes must be reported on a cash basis. Typical categories of expenses are as follows:
1. Fixed Expenses. Fixed expenses are those that generally do not vary with occupancy and have to be paid regardless of whether the project is occupied or vacant, and generally do not fluctuate greatly from year to year. Real estate taxes and insurance costs are typically included as fixed expenses.
  2. Variable Expenses. Variable expenses are operating expenses that vary with the level of occupancy or the intensity of project operation. Operating expenses for large properties frequently list many types of expense variables, but typical broad categories include the following:
    - a. Management charges
    - b. Utilities – electricity, gas, water, sewer charges
    - c. Heating and air conditioning (HVAC)
    - d. General payroll and security
    - e. Cleaning expenses
    - f. Maintenance and repairs
    - g. Decorating
    - h. Grounds maintenance
    - i. Exterminating
    - j. Trash removal
    - k. Miscellaneous (supplies, etc.).
  3. Reserve for Replacements. This reserve category provides for the periodic replacement of the building components that wear out more rapidly than the building shell itself and must be replaced periodically during the building's economic life. These components may include but are not limited to roof covering, carpeting, plumbing fixtures, appliances and HVAC. The estimate of the reserve for replacements should be based on reserves that are typically collected for comparable properties in the subject's market area, without regard to FHA programmatic requirements and formulas used for determining the required replacement reserves when calculating debt service coverage. The appraiser must document the research conducted to make this determination. The MAP Lenders underwriting narrative must address any variance between the market reserve cost use on the appraisal and the FHA required deposits included in the underwriting.

4. Total Operating Expenses. Total operating expenses for residential properties are the sum of the fixed expenses and variable expenses updated to the appraisal date, plus the reserve for replacements.
  5. Commercial Facilities. Where commercial facilities are included in the subject project, a separate analysis must be made to determine the effect that the commercial operation will have on the project expense estimate.
- D. Estimate of operating expenses by units of comparison. Items of expense shown under each comparable and the expense items applicable to the subject proposal must be expressed as suitable unit of comparison—such as expense per unit per annum (PUPA), expense per room per annum (PRPA), and expense per square foot of net rentable area per annum (PSFPA), or percent of effective gross income. The expense comparables and units selected must be as similar as possible to the subject project and units as they relate to the subject location, structural type, number of bedrooms, and average unit size.

For consistency purposes, expense components must be expressed in the same units of comparison so that the expenses for the subject proposal can be totaled. However, if the unit of comparison for a specific component is different from the basic unit of comparison for the other expense items, this different unit of comparison must be explained in the expense narrative. The dollar amount of the expense item can afterwards be converted to the same unit of comparison selected for the other expense components. Additional documentation must be submitted, as needed, for all component estimates that are not self-explanatory.

- E. Expense Comparables. All insured properties used as expense comparables must be identified and disclosed in the appraiser's Form HUD-92274, expense analysis and in the appraisal, except as noted below.
1. General Requirements. All comparables (confidential and disclosed) must be representative of the physical and location-specific characteristics of the subject project. Appraisers must always present the best comparables available for their analysis and must refrain from repeatedly using the same disclosed comparable merely to meet the disclosure requirement.
  2. Confidential Expense Data. The appraiser may include confidential expense comparables in the expense analysis, however the analysis must include at least one fully identified and disclosed expense comparable to serve as a benchmark. Confidential expense data sources must be disclosed to HUD review appraiser upon request (and subject to confidential requirements similarly imposed on licensed HUD review appraisers). Appraisers may only use confidential expense comparables that are supportive and consistent with the fully disclosed comparables used in the analysis. When submitting confidential expense comparables, the appraiser must redact only the minimum amount of information necessary to protect the confidentiality of their client. The city, state, and general market area within the city must be disclosed unless this information would clearly identify the comparable and thus breach the appraiser's confidentiality requirement. The project description,

unit mix, and the physical characteristics of the comparables' units must be disclosed. It is unacceptable for the appraiser to base conclusions on confidential expense comparables that are not supported by the fully disclosed comparables used in the analysis.

3. Review of Insured Expense Comparables. The HRA will compare the FASS or OPIIS systems file for the insured expense comparables used by the appraiser to confirm the data. In order to accomplish this, the HRA will combine the following accounts: Acct. No. 6263T, Administrative Expenses (subtract Acct. No. 6203, Conventions and Meetings, and 6370, Bad Debts), Acct. No. 6400T, Utility Expenses, Acct. No. 6500T, Operating and Maintenance Expenses, and Acct. No. 6700T, Taxes and Insurance.

- F. Expense Adjustments. Project expenses must be expressed in the same units of comparison in order to ensure accurate adjustments and correct reporting of expense estimates. Consistent adjustments for significant differences between the comparables and the subject units shall be derived from the market and applied to the subject expense estimate.

The appraiser must enter the dollar amounts attributable to significant differences between the subject proposal and each of the expense comparables—such as for physical characteristics, equipment, services provided, the level of management furnished to residents and any differences in rates between tax and utility jurisdictions. The appraiser must correlate the comparable expense for each component which is applicable to the subject project.

- G. Updating Procedures. Appraisers must not trend expenses to reflect a time adjustment from the effective date of the most recent expense comparable to the anticipated date of project occupancy following construction and initial endorsement. Instead, expense estimates must be effective as of the date of the appraisal and must reflect the same year of operation.

The appraiser may use a factor expressed as a percentage to adjust expense comparables up to the same date as the most current expense comparable in order to make a more creditable comparison. However, if all of the expense comparables have data from the same operating year, no adjustment for updating is necessary.

Adjusting expense data is a two stage process, as follows:

First, the oldest comparables are updated to the date of the most recent comparable, so that all comparable data is representative of the same effective time period. Second, after updating the comparables to the same effective time period, the line items are correlated and the subject's expense estimate is updated to the date of the appraisal.

1. The most current comparable is entered in the first column on the HUD 92274. This comparable serves as the benchmark for updating the remaining comparables.
2. The effective date of the operating expense data is always the beginning date of the operating year. For example, the beginning date of a financial statement dated January 1<sup>st</sup> to December 31<sup>st</sup> is January 1<sup>st</sup> of that year. If the financial statement fiscal year ends June 30, 2000, the beginning date is July 1, 1999.

3. Other than the first comparable being the most recent, the remaining comparables do not necessarily need to be in chronological order.
  4. The appraiser must enter the comparables itemized expenses as reported on audited, reviewed or certified financial statements. Per unit expenses or per square foot expenses are treated similarly:
    - a. The actual expense amount must be entered in the first column, without any adjustments.
    - b. Once the adjusted per unit expenses are determined for each comparable, the subject project's expenses are then correlated from the array.
    - c. Once the correlated line item expenses for the subject project are determined, they are added and updated to the date of the appraisal.
    - d. The correlated subject expenses are updated based upon the beginning date of the expense period of the most recent (the benchmark) comparable. HUD may request from the appraiser the names and addresses of any confidential expense comparables used in the expense analysis, pursuant to the Confidentiality sub-section of the Ethics Rule, along with Standards 3.1.e and 3.2.f of the USPAP. If the appraiser still refuses to provide this information, the HRA may request additional non-confidential comparables.
- H. The expense line items included in the Section E. of HUD-92264 should be consistent with the individual line items as updated, on the HUD-92274.
- I. Underwritten NOI and General Programmatic Guidance. The following general guidance should be used by underwriters. Assumptions that raise underwritten risks should be stress tested against worst case scenarios and should be evaluated by the underwriter.
1. Occupancy Standards. Projects must have an average physical occupancy rate of at least 85%. For market rate properties, the maximum underwritten economic occupancy rate is 93%. For affordable<sup>1</sup> properties, refer to the Section 7.7G.
  2. Projects must demonstrate a pattern of stable physical occupancy, i.e. the average occupancy standards noted above, for a period of six months prior to submission of the Firm Commitment application, and maintain that average occupancy through to the date of Initial/Final Endorsement. Continued occupancy consistent with the underwriting conclusions must be documented with an updated rent roll no more than 30 days prior to closing.
  3. The Borrower must submit an updated, certified rent roll detailing the occupancy level at the project. The rent roll must be dated no more than 30 days prior to endorsement. If HUD determines that the updated rent roll shows a significant change in occupancy from that submitted at the time of application and that was assumed in the loan approval, then any Commitment issued shall be of no force or effect and will be cancelled by HUD.
  4. Operating Expenses will be stabilized based on the previous three-years operating history where available. Operating expenses, as evidenced by the three year operating history may require

adjustment if capital expenditures (normally considered a reserve for replacement item) have been paid out of the operating budget. Additionally, adjustments to management fee may be made provided a new management contract is executed which reflects a different percentage of gross collection. Adjustments to real estate taxes may be permissible if there is an anticipated tax reduction based on reassessment or reclassification. Annual deposit for the reserve for replacement will be based on either the formula method or the estimate made by the needs assessor in the Capital Needs Assessment.

5. **Exceptions:** Set forth below are exceptions to developing NOI for underwriting Criterion 5 (debt service):

a. Projects with units assisted under a Section 8 HAP contract subject to marking down to market or having short terms will size the debt service mortgage at the lower of either:

1. Market rents as estimated by the third party appraiser, or
2. Section 8 HAP rents

b. Projects that will have Section 8 HAP contracts with above market rents assured for a long term may amortize the additional debt within Criterion 5 (debt service approach) based on two tranches, an A and B piece.

1. The A piece will be determined by underwriting to the market rent levels over the entire term of the mortgage.
2. The B piece will be underwritten as the difference between the market rents and the higher Section 8 rents over the remaining term of the HAP Contract.

c. First-time refinance of a 202 direct loan. Criterion 5 may use the Section 8 HAP rents (even if they exceed the market). Actual project expenses, as evidenced by the three-year operating history as stabilized, will be used. This assumes that these projects are not subject to restructuring under Mark to Market and that no equity will be extracted in the transaction based on above market rents.

d. Re-refinance of projects which previously had Section 202 direct loans will use the two-tranche method described above. These projects are no longer subject to mark to market under MAHRA at the next HAP contract renewal exemptions.

e. Tax Increment Financing (TIF): The TIF income may be underwritten as a second tranche for the term of the TIF only to the extent the offset request NOI is guaranteed or refinanced to obtain anticipated benefits and the TIF would unquestionably not result in a default. The underwritten narrative must provide a complete explanation of the TIF and stress test analysis.

- f. Low Income Housing Tax Credit Projects (LIHTC). Debt Service rents will be the lower of market or tax credit restricted rents unless there is a Section 8 HAP contract that covers the LIHTC rental units. In the case where there is a Section 8 contract and the tenants will pay no more than the tax credit restricted rents for their portion of the rent, then the lower of market rents or Section 8 rents will be used.
- g. Energy/Utility Efficiencies. Up to 75% of projected savings from energy/utility efficiencies may be underwritten if the projection is based on the CNA e Tool and/or an ASHRAE Level II energy audit, and if the proposed scope of work includes the energy/water efficiency upgrades used in the projections.

See Table in Appendix 7 – Criteria for Loan Sizing, for a summary of Exceptions.

## **7.9 Site Analysis**

Key analyses for consideration of site acceptability for a proposed project are as follows:

- A. Analysis of Location. The analysis of location involves a determination of the desirability and utility of the site, probable future neighborhood trends, the pattern of project and neighborhood improvements and rents in the area.
- B. Specific Location. Consider the specific site in relation to neighborhood and city-wide physical, social, and economic influences, limitations of use imposed by zoning or deed restrictions, development trends, stability, decay and rehabilitation, availability of utilities, services, and appropriateness of the intended use. Review and analyze the various influences which affect its market and income potential, including a review of the crime rate in the area, its impact on the project and how the impact, if any, can be addressed through design or staffing. Racial, ethnic or other demographic characteristics of Fair Housing Act protected classes may never be taken into account when conducting an appraisal. No decisions should be made based on pre-conceived notions about characteristics of the area based on the demographics in lieu of statistics. (For further guidance, consult USPAP Advisory Opinion 16, “Fair Housing Laws and Appraisal Report Content”).
- C. Civic, Social and Commercial Centers. Consider the sufficiency of community facilities as they relate to the needs of residents of the proposed project. A location for a multifamily project must be adequately served by elementary and secondary schools, neighborhood shopping centers, transportation, churches, playgrounds, parks, libraries, hospitals, and theaters and other appropriate services.
  - 1. Schools. Accessibility to schools will be judged by the transportation time required, rather than by walking distance alone. Thus, if school bus service will be provided and the time involved is reasonable, the location may be acceptable even if schools are not within walking distance. School capacity is the responsibility of the community and a project that is otherwise feasible will not be rejected because the local schools are considered overcrowded, unless it can be proven that marketability is adversely affected.
  - 2. Neighborhood Shopping Centers. The convenience of shopping should be judged on the basis of

time rather than distance. The importance of grocery, drug, and other neighborhood shopping facilities to be within a reasonable walking distance will be heightened based on the number of residents who do not have private transportation.

3. Religious and Recreation Centers. Ready access to religious and recreation centers is desirable. Projects designed for large families have a greater need for playgrounds and active recreation areas. Adequate on-site provisions for playgrounds and other recreation amenities must be incorporated into the proposal where adequate facilities are not in close proximity to the project site and available for use by occupants.
- D. Transportation. Convenient transportation to places of employment, major shopping districts and civic and social centers is a prerequisite to site acceptability. In those communities where local public transportation is the principal means of commuting by the prospective residents, the location of a project designed for such occupancy shall be within a reasonable walking distance to mass transit.
- E. Special Hazards and Nuisances. Such conditions include unusual topography, subsidence, flooding, unstable soils, unusual traffic hazards and noise, danger from fire and explosion, exposure to airport noise and low-flying airplanes, smoke, chemical fumes, noxious odors, stagnant ponds or marshes, and sewage disposal failure. Any of these, or similar conditions, if serious and infeasible to overcome, will cause a specific location to be ineligible for mortgage insurance.
- F. Parking Facilities. The lender and the third party reports must consider the impact that parking requirements for the project will have on parking facilities in the neighborhood and on all-night parking, including the availability of other off-street parking, if the project site lacks adequate parking for residents. The loan proposal must estimate the number of parking spaces that would be required and whether or not the proposed parking facilities will meet the estimated need of the residents and their guests. Convenient access to reliable public transportation may in some cases mitigate parking availability concerns.
- G. Site Suitability. The site must be adequate in size, shape, exposure, and contour for the proposed project. Building height limitation, project unit size and numbers, necessary on-site parking and play areas must be considered.
- H. Sites/Projects Sold by a Public Body.
1. The site value of land in new construction is to be estimated using all applicable approaches to value, as if the project were unrestricted and market rate.
  2. The "As Is" value in substantial rehabilitation cases is to be estimated using all applicable approaches to value based on the current operation of the project.
  3. For both 1 and 2 above, no consideration will be given to:

- a. Any additional value that may be attributable to subsidies available to the project or any LIHTCs or other tax benefits the project will receive; or
- b. Any value reduction due to any NOI or value limitations caused by regulatory agreements or affordability restrictions imposed by any subsidy program or tax regulation. This valuation methodology permits sponsors to acquire a project at its market value for new construction or rehabilitation of affordable housing. The value attributable to the presence of LIHTCs diminishes over time and is not always freely transferable, and thus should not be taken into consideration.

**NOTE:** See special instructions for Cost Certification as it relates to As Is Valuation in Chapter 13.21.

4. The site value of land in new construction or the “As Is” value will be noted in the MAP appraiser’s narrative report and in the Remarks section of the form HUD 92264. For the purpose of developing the cost build-up in Section G of the form HUD 92264, the lesser of market value or the acquisition cost will be entered in Section G. Line 74 (Total Estimated Replacement Cost of the Project) is to be entered in Criterion 3 of the form HUD 92264-A.
5. Sites/Projects Sold by a Public Body. For underwriting purposes, where sites/projects are sold by a public body to the developer for a specific re-use purpose, the value of land fully improved is the lesser of:
  - a. The amount determined by comparison with other sites possessing the improvements and amenities that the subject site will have upon completion.
  - b. The dollar amount paid by the purchaser under the purchase contract with the public body, plus an estimate of any additional costs imposed by its terms or by the insurance program. Such costs are those to be borne by the purchaser under the purchase contract including real estate taxes and special assessments accruing from date of purchase to date of commitment, legal fees incident to the land/project purchase, re-zoning costs, installation of certain designated off-site improvements, razing structures and clearance of the site (after allowance for any income to the purchaser). This is not a complete list of items covered, but serves as a guide to the acceptability of costs required by the purchase contract.
  - c. The actual values are noted in the MAP Appraiser’s narrative and in the Remarks Section of the 92264.
6. “As-Is” Value of Land. HUD’s estimated value of land or project “as is” for cost certification may include all of the items in paragraph 1.b above with the following exceptions: Installation of off-site improvements and cost of razing structures and clearing the site (less income received). This is intended to avoid duplication of costs that might be reflected in the estimated value of land “as is” and also allows for the sponsor to include them as separate items in cost certification which

includes both off-site costs and demolition. The dollar amount of the land purchase contract plus a breakdown of the estimate of additional costs must be fully itemized and documented.

- I. Site Value for Subsidized and/or LIHTC Projects: The site value is to be estimated using a capitalization rate and project NOI as if the units and the project were unrestricted and market rate, without considering: a) any additional value that may be attributable to subsidies available to the project or to any LIHTCs or other tax benefits the project will receive, or b) any value reduction due to any NOI or value limitations caused by regulatory agreements or affordability restrictions imposed by any subsidy program or tax regulation. This valuation methodology permits sponsors to acquire project at its market value for new construction or rehabilitation of affordable housing. The value attributable to the presence of LIHTC's diminishes over time and is not always freely transferable, and thus should not be taken into consideration.
- J. Warehousing of "excess" land area is not encouraged but where un-avoidable, it may be permitted but may not be funded with insured mortgage proceeds.

## **7.10 Pre-Application Stage for Sections 220, 221(d) and 231**

- A. Lender's responsibilities:
  - 1. Based upon the market study prepared by the market analyst and the rental income and expense estimates prepared by the appraiser, the lender is responsible for making the following determinations before submitting the application:
    - a. Determine the current occupancy levels, market absorption rates and market demand for the number and type of units proposed.
    - b. Analyze site for acceptability.
    - c. Determine market rents reflecting amenities, services, equipment offered and estimate project income.
    - e. Estimate total operating expenses.
    - f. Estimate mortgage amount based on form HUD-92264-A, Criteria 5, and Debt Service Ratio.
    - g. Make a determination of feasibility or non-feasibility of the sponsor's proposal.
    - h. Evaluate the market study and appraisal report. The lender will either accept their conclusions for use in underwriting, or may revise them for underwriting purposes. Any such revisions must be explained and justified. The lender may adjust the appraised value downwards but may not adjust it upwards. Once accepted by the lender, and submitted to HUD as part of the lender's application, the lender represents the findings and conclusions of the appraisal.
  - 2. The Phase I ESA report must be prepared in accordance with Chapter 9 and the lender should advise the market analyst and the appraiser of any conditions which might affect the marketability or value of the project.

3. The appraiser or market analyst must prepare the market study in accordance with the requirements of this Chapter.
4. The appraiser must determine project rents, estimated rental income, operating expenses the warranted price of land or “as is” value (of land and buildings for substantial rehabilitation cases). The lender must assure that the forms HUD-92273, Estimate of Market Rent by Comparison, and HUD-92274, Operating Expense Analysis Worksheet, are prepared. For substantial rehabilitation projects, the appraiser must estimate the rents and expenses based on the assumption that all proposed substantial rehabilitation to the project has been completed and is used as the basis for NOI in the debt service criterion. However, pre-rehabilitation rents and operating expenses must be used for purposes of developing the cost build up and determining as-is value.
5. The lender must consider cost information from various sources, including the sponsor, appraiser, and cost consultant (including soft-cost and land cost information) to calculate the total replacement cost and will compare its estimate of total replacement cost with the costs estimated by the borrower.
6. Complete the forms HUD-92264, HUD92264-A, and supporting forms.
7. The lender must compare the calculations on the form HUD-92013 with those proposed by the borrower and either accept the borrower’s proposal, recommend its modification, or reject it and advise the borrower that the project is infeasible.

## **7.11 Firm Commitment Processing for Sections 220, 221(d) and 231 (New Construction)**

### **A. Lender’s Responsibilities:**

1. Contract for an appraisal establishing the replacement cost for the project utilizing the cost approaches in accordance with requirements found in Section 7.6. The appraiser will update the rental and expense analyses provided in the Pre-Application.
2. The appraiser is also required to determine the “warranted price of the land” for new construction projects and the "as is" value of the project for substantial rehabilitation projects. In addition, for Section 231 substantial rehabilitation projects, the appraiser must also determine the “value fully improved” of the project site.
3. The lender must forward or otherwise coordinate sharing information prepared by its cost analyst and any soft-cost and land cost information provided by the sponsor with the appraiser for assistance in the calculation of the total replacement cost.

In accordance with USPAP Standard 2-3, “When a signing appraiser(s) has relied on work done by appraisers and others who do not sign the certification, the signing appraiser is responsible for the decision to rely on their work. The signing appraiser(s) is required to have a reasonable basis for

believing that those individuals performing the work are competent. The signing appraiser(s) also must have no reason to doubt that the work of those individuals is credible.”

4. The lender must assure that all applicable sections of the Rental Housing Project Income Analysis and Appraisal, form HUD-92264, are completed in accordance with current policy, for the type of project proposed.
5. Form HUD-92664 items to be calculated by the appraiser include:
  - a. Market rents and estimated income
  - b. Estimated total operating expenses
  - c. Total estimated replacement cost of the project
  - d. “Warranted Price of the Land” for new construction projects and the "As Is" value of the land and building for substantial rehabilitation projects
  - e. Estimate of operating deficit and replacement reserve
  - f. Estimate of REL
  - g. Estimate of Interest during Construction (line 53 in section g of Form HUD-92264), to be calculated as the greater of:
    - 1) By formula. The amount of the mortgage multiplied by 0.5, multiplied by construction interest rate and multiplied by construction years. (Construction Years is the construction time in months from line 52 in section G of the Form HUD-92264 plus 2 months, then divided by 12).
    - 2) Lender’s estimate (optional). The lender’s estimate of interest during construction must be documented with a pro-forma draw schedule or its equivalent, subject to USPAP Standard.
    - 3) HUD’s HRAs have the option to modify appraisal conclusions internally or to return the application to the lender for modification. See Chapter 11 Section 11.2 for review by MF Regional Center/Satellite Office staff.
6. The lender must provide written explanations in the underwriter’s narrative of and major changes to the pre-application invitation letter. Any inconsistency between the data reported on a form HUD-92264 prepared by the appraiser and the lender’s HUD-92264 must be explained in the Underwriting.

## **7.12 Firm Commitment Processing for Section 223(f)**

### **A. Lender’s responsibilities:**

1. The Underwriting Narrative must demonstrate that the MAP Underwriter performed adequate due diligence in reviewing the appraisal which shall include a thorough discussion comparing

the appraiser's market analysis to the conclusions from the market study, in cases where a separate market study is required. There must also be a full discussion by the underwriter of the approaches to value and the appraiser's reconciliation and value conclusion.

2. The lender must state any reasons for disagreement with the appraisal report. The underwriting summary should contain a thorough discussion of any differences between the value conclusions made by the appraiser and those conclusions used in underwriting the loan. The appraiser's value conclusions may be adjusted downwards by the underwriter but may not be adjusted upwards.
3. The appraiser must complete an appraisal of the project establishing market value utilizing the cost, income, and comparable sale approaches. The Cost Approach may be eliminated at the discretion of the appraiser for subjects that are ten or more years old, although an estimate of the land value must still be provided.
4. The appraiser should where practicable participate in the inspection of the project with the Needs Assessor as described in Appendix 5G.
5. The appraiser must consider the eligibility of the project, confirm the project occupancy level, and verify the owner's rent roll during the inspection. When the appraiser has established that the owner's rent roll is correct, the actual occupancy, based on the owner's rent roll must be entered in the Remarks Section of Form HUD-92264. The appraiser must also determine whether the apartments are furnished or unfurnished.
6. The appraiser must analyze the project for acceptability.
7. The lender must confirm that the Phase I ESA and narrative report is prepared in accordance with all appropriate directives.
8. The lender must assure that the appraiser completed the forms HUD-92273, Estimate of Market Rents and HUD-92274, Operating Expense Analysis Worksheet. This is based on the determination made by the appraiser of the project's income and operating expenses including a review of the operating history of the project (rent roll and financial statements).
9. The lender must assure that all applicable sections of the Rental Housing Project Income Analysis and Appraisal, form HUD-92264, are completed in accordance with current policy, for the type of project proposed. HUD-92264 items to be calculated by the appraiser include:
  - a. Market rents and estimated income
  - b. Estimated total operating expenses
  - c. Total estimated replacement cost
  - d. "Warranted Price of the Land"
  - e. Market value of the project

- f. Estimate of operating deficit and replacement reserve
  - g. Estimated and actual occupancy rate
  - h. REL
10. The data provided in the lender's HUD-92013 and HUD-92264 must be consistent and any inconsistency between the data reported on a HUD-92264 prepared by the appraiser and the lender's HUD-92264 must be explained in the Underwriting Summary.
11. The lender must assure that the Remarks Section of HUD-92264 contains the following information:
- a. The appraiser's statement of actual occupancy, based on the owner's rent roll.
  - b. The required amount of initial deposit into the Reserve for Replacement.
  - c. The estimated cost of required repairs as provided in the inspection report.
  - d. The estimated amounts for legal, organizational (if applicable), title and recording expenses based on the maximum insurable loan.

### **7.13 Substantial Rehabilitation Processing for Sections 220, 221(d)(4) and 231**

- A. In general, a substantial rehabilitation project is processed in accordance with the instructions found in Sections 7.10 and 7.11, except as noted below.
- B. Form HUD-92264 must be completed in accordance with basic valuation instructions for Sections 221(d) and 220 processing, with the following modifications:
- 1. "As Is" Value. Development of the "As Is" value must be in accordance with the pertinent requirements of Standards 1 and 2 and the applicable approaches to value. A supplemental HUD 92264 is not required.
  - 2. The forms HUD-92273 and HUD-92274 analysis used to support the income and expenses on the HUD-92264 must reflect the "as completed" project conditions that will exist after substantial rehabilitation has taken place.
  - 3. A value for the land without improvements must be estimated and entered using the analysis grid in Section H of the form HUD 92264.
  - 4. The "as is" value and the value of the land without improvements must be entered in Section "O" (Remarks) of the form HUD 92264.
- C. Applicable Approaches - "As Is" Value in Substantial Rehabilitation. The estimate of "As Is" value of the land and building before rehabilitation should be estimated by the direct market comparison approach and the income approach to value. The "As Is" value by the residual approach is not

mandatory, but can be used in cases where there is a lack of market sales. This estimate of value assumes an arm's length transaction between the subject and a typical purchaser of the subject in its current state with respect to condition and income, including the current presence of a subsidized income stream. To determine value based upon the income approach, the appraiser should use the lesser of market rent or the income derived from any rental assistance contract, as applicable, to avoid inappropriately inflating income and thereby the estimate of value. Moreover, the estimate does not assume any advantages or disadvantages associated with the current sale or refinancing of the subject that would involve issuance of tax credits or other development advantages.

NOTE: See special instructions for Cost Certification as it relates to As Is Valuation in Chapter 13.21.

D. Valuation Processing: (Sections 220, 221(d)(4)).

1. Determine the market value of the project "As Is". Complete the Location and Description of the Project, Information concerning Land or Project, Estimate of Income, Equipment and Services Provided in Rent, Estimate of Annual Expenses, Income Computations, and Income Approach to Value, and Sales Comparison Approach to Value within the report. If the project involves rehabilitation and new construction with additional land to be added, also complete a land appraisal for that portion of the land to be added for the new construction portion of the development proposal.
2. Use the Replacement Cost by Formula, Rehab Projects, with or without BSPRA, to find the total project cost (summation estimate) using the "As Is" market value of the project, and the rehabilitation cost estimate furnished by the cost analyst, plus carrying charges and financing.
3. Complete HUD-92264. In Section G, the "As Is" market value of the project before rehabilitation will be shown on the line titled "As Is" value of project except as noted below.
4. "As Is" value of project acquired as a leasehold estate. Instructions for limiting the "As Is" value of project before rehabilitation, when that project is acquired as a leasehold estate, are found in Ground Leases, Section 7.16.
5. To find the project mortgage amount for Section 220 and Section 221, use the lower of Criteria 1, 3, 4, or 5 on HUD-92264-A. Estimate the "As Is" value of the project before rehabilitation, add the total for all improvements plus soft costs to the As-Is Value to obtain the sum of the above costs. Then multiply the sum of the project costs listed above by 90 percent based upon Criterion 3 to obtain the maximum project mortgage amount.

**NOTE:** Cost Certification instructions (set by Statute) dictate that the **lesser** of the "as is" value of the land and improvements (before repair or rehabilitation) **or** the purchase price of the land and improvements, is used in the cost build up for Criterion 3 of form HUD 92264A, in substantial rehabilitation cases. Consequently when mortgage proceeds will be used to fund the acquisition of the project, the "as is" value estimation will be used as a test of the reasonableness of the acquisition price.

When the acquisition price is less than the "as is" value of the land and improvements (as accepted

by HUD), and mortgage proceeds will be used to fund the acquisition of the project, the acquisition price will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment

When the acquisition price exceeds the “as is” value of the land and improvements (as accepted by HUD), then the acquisition price must be reduced to the “as is” value and will, subsequently, comprise the basis of the cost build up for the Firm Commitment.

When mortgage proceeds will **not** be used to fund the acquisition of the project, the “as is” market value of the project will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment. This is particularly significant when below market rent restrictions, (such as in the case of LIHTC limited rents or Section 8 rent subsidy) are in place and the use of market rents in valuing the project will result in a premium over these rent restrictions. (See Section 7.13 C, defining how rents are derived as the basis for the “as is” value)

E. Valuation Processing for Section 231 Substantial Rehabilitation Cases. Section 231 substantial rehabilitation cases requires two value estimates, a value subject to the completion of rehabilitation using all applicable approaches, which shall be used in Criterion 3 of the Form HUD-92264-A, and an “As Is” value entered in Section G, line 73b of the Form HUD-92264 to determine the Total Replacement Cost of the Project, in a manner similar to the procedure used in Sections 220 and 221(d) (4). Depreciation is not included. The value upon completion of the project should reflect that which could be obtained through an arms-length sale. If rental restrictions exist and will survive post sale, then the value will be based upon these limitations. Alternatively, if the restrictions terminate upon sale, then the As-Is estimate would reflect the higher value. The “As Is” value is also used in completing Criterion 6 of the Form HUD-92264-A.

If the Total Estimate Replacement Cost of the Project (Line 74 of Section G of the 92264) exceeds the value after rehabilitation, the residual “As Is” value by formula must be completed. This amount must be entered on line 73b of Section G, and Section G, line 74 will be considered to be the value of the project after rehabilitation and this amount must be entered in Criterion 3 of the Form HUD-92264-A.

F. Valuation Processing for RAD Transactions. On RAD 221(d) (4) substantial rehabilitation transactions, the appraiser should use the CHAP rents and historical occupancy and operating expenses if available to set value.

G. Contingency Reserves. To address unanticipated costs inherent in the rehabilitation of older structures, there will normally be included in the mortgage amount a reserve for contingencies based on the percentage of estimated rehabilitation cost without fees. This percent may range between 10 and 15 percent, depending upon the scope and type of rehabilitation and the experience and financial ability of the sponsor, the borrower and contractor and on whether the contractor’s bid already contains a reserve for contingencies. This percentage, determined by the cost analyst, must be included as a separate line item in the estimate of replacement cost on HUD-92264.

H. Interest during Construction. Interest during construction in either new construction or substantial rehabilitation (line 53 in section G of Form HUD 92264) must be calculated as the greater of:

1. By Formula. The amount of the mortgage multiplied by 50 percent, multiplied by construction

interest rate and multiplied by construction years. (Construction Years is the construction time in months from line 52 in section G of Form HUD-92264 plus 2 months, then divided by 12).

2. Lender's Estimate (optional). The lender's estimate of interest during construction must be documented with a pro-forma draw schedule or equivalent.
- I. Inspection Fee. The inspection fee is calculated as half of one percent (0.5%) of the loan amount when the project involves new construction. For substantial rehabilitation projects, the inspection fee is calculated as the sum of Total for All Improvements (plus BSPRA, if applicable), times one half of one percent (0.5%) rounded to the next higher \$100.
- J. Offsite costs. If there are any offsite costs associated with the rehabilitation, enter them as a line item in the Estimated Replacement Cost. This separate entry is necessary in rehabilitation processing, since the "As Is" value does not include offsite cost requirements.
- K. Rehabilitation cost not attributable to residential use. This entry must be completed for all rehabilitation projects and is prepared on Rehabilitation Cost Not Attributable to Residential Use, found in the MAP Form Book, and transferred to line 4b under Criterion 4, Amount Based on Limitations per Family Unit, HUD-92264A.
- L. Developer's Fee, when applicable. HUD may include in the estimated replacement cost of a project, a nonprofit developer's fee in addition to the legal, organizational and audit fees normally included in the estimated replacement cost of a project.
  1. The fee will be based on a sliding scale at eight percent of the mortgage, but not less than \$40,000 or more than \$400,000.
  2. Exceptions:
    - a. For mortgages in excess of \$5,000,000 increase the maximum fee to provide an additional 2 percent based on that portion of the mortgage that is in excess of \$5,000,000.
    - b. At the option of the nonprofit sponsor/borrower, the fee included in the replacement cost may be reduced.
  3. Part or the entire fee may be used to pay for transactional costs related to developing the subject project including but not limited to:
    - a. Reduction of the estimated closing costs of the project
    - b. Staff salaries
    - c. Nonprofit working capital deposit
    - d. Relocation expenses
    - e. Operating deficit escrow
    - f. Financing fees above the 3.5 percent included in the estimated replacement cost of the project;
    - g. Environmental studies

- h. Housing Consultant services provided by either in-house staff or contractor
  - 4. Funds not used to meet the estimated cash requirements of the project will be released to the nonprofit based on a percentage of completion method.
- M. Items no longer included in the Estimated Replacement Cost of a Project. HUD will no longer include in the estimated replacement cost of a project, an Allowance to Make Project Operational (AMPO) and an amount for Housing Consultant services except as part of the developers fee noted above.

## **7.14 Calculating Operating Deficits**

- A. Estimate of a Project's Operating Deficit. When it is anticipated that the project's net income will be inadequate to support the insured loan during the initial rent-up period, the appraiser must estimate the anticipated project operating deficit, utilizing the following steps:
1. Estimate the total project operating expenses, add the debt service requirement (including principal, interest and mortgage insurance premium (MIP)) and divide the total by the potential gross income for the project. The resultant ratio is the break-even occupancy level. Multiply that percentage times the total project units to obtain the number of units required for break-even occupancy (rounding up any fraction of a unit).
  2. Estimate the total number of units expected to be occupied at the time of Final Endorsement. The difference between the total units required for break-even occupancy and those occupied units at the time of Final Endorsement represent the total number of units that must be rented in order to reach a break-even occupancy level.
  3. Estimate the likely rate of absorption of the available units, taking into account the current and proposed supply of housing units in the subject's market balanced against demographic and demand considerations. The absorption or lease-up rate must be supported by comparison to similar project's historic rates of absorption during their lease-up period whenever such a comparison can be made. The number of units to be absorbed, divided by the monthly absorption rate, will yield the total number of months of the entire operating deficit period.
    - a. Absorption Period. The Absorption Period is the period of time necessary for a newly constructed or renovated project to achieve stabilized occupancy. The absorption period begins when the first certificate of occupancy is issued and ends when the last unit to reach stabilized occupancy has a signed lease and is actually occupied by a resident. A typical pre-marketing period begins about three to six months prior to the issuance of the certificate of occupancy, therefore the month that leasing is assumed to begin should accompany all absorption

estimates. It is important to consider that the absorption of restricted/low-income units may be different, depending on the differential in rent between low-income rents and market rents, and the number of income-qualified potential residents in the HMA.

- b. **Maximum Allowable Absorption Period.** As a result of risk mitigation guidance, the absorption period used in estimating market demand for the proposed number of units has been reduced from 24 to 18 months. Larger projects may phase additional units under a separate application for mortgage insurance (e.g. under Section 241(a)). An exception to the 18-month absorption period limitation may be waived by the Regional Center Director for large high-rise buildings. Such projects will be evaluated based on their own merit and will require a larger initial operating reserve to insure against the risk inherent in a longer absorption period.
  - c. **Absorption Rate.** The Absorption Rate is the average number of units rented each month during the absorption period.
4. Because the deficit period can begin at certificate of occupancy and continue through the cost certification phase and the amortization phase, there are three distinct expense intervals to consider when calculating the total deficit period, although not every project will require using all three intervals.

**Interval 1** covers the time between certificate of occupancy and the end of the construction period and cost certification . (Note that the construction period is defined as construction time plus two months for cost certification purposes). This is an optional interval, because some projects may have the same certificate of occupancy and construction completion dates and thus would not need an Interval 1. When calculating expenses for this Interval, no debt service is to be included as an expense since the mortgage interest for this interval is included in the mortgage in Section G Line 53 "Construction Interest". Replacement Reserves and ground rent are not to be included in Interval 1. This interval must only include the appraiser's estimate of all of the applicable operating and leasing expenses for each month (period).

**Interval 2** begins at the end of the construction period/cost certification process (construction time plus two months) and ends at the beginning of loan principal amortization. This period can be no greater than 2 months and is also an optional interval. (Chapter 8 Section 8.9.A.2. requires amortization to begin "no later than 4 months after construction completion for insurance of advances and first day of second month after final endorsement for insurance of completion cases"). If amortization begins at the end of the construction period, this interval will not be necessary. Debt service must include payment of interest and MIP, but not amortization, as the beginning of amortization signals the beginning of Interval 3. (Section G Line 53 of the HUD-92264 includes mortgage interest for the construction period plus two months. If amortization is deferred until 4 months after construction completion, there will be two months of unaccounted-for interest and MIP that must be included in the IOD). Ground rent must be included if the project is a leasehold since only ground rent during construction can be included in the mortgage, and this interval begins after construction completion. Replacement reserves are not included in interval 2.

This interval must include the appraiser's estimate of applicable operating expenses for each month (period).

**Interval 3** begins at the beginning of amortization. Amortized debt service is mandatory in this interval, and must include payment to principal, interest and MIP. Ground rent, if applicable and replacement reserves are also mandatory in interval 3. This interval must include the appraiser's estimate of applicable operating expenses for each month (period). Interval 3 ends when NOI becomes positive and is sufficient for breakeven coverage of the mortgage debt.

- B. Operating deficits can occur before and after the start of amortization. The operating deficit calculation for the first interval must begin when the Certificate of Occupancy is secured.
- C. If the dollar amount of debt service for a period is greater than the net income for that period, the difference represents the estimate of the operating deficit. One period of positive income does not cancel a prior period of income deficiency.
- D. The operating deficit represents the total of all cumulative losses projected to occur before the project reaches breaks even and produces a positive cash flow. These losses may not be offset by intermittent periods of positive cash flow.
- E. Where commercial facilities are included in the project, a separate operating deficit estimate of income loss for commercial rent-up must be prepared. The appraiser must insure that expenses included in the residential deficit estimate are not duplicated in the commercial space deficit estimate so as to unfairly penalize the project. The commercial space deficit is added to the residential operating income deficit to determine the total project operating deficit escrow funding that will be necessary. Any positive income attributable to the commercial space during the deficit period will not offset the residential operating deficit requirements.

## **7.15 Leaseholds/Ground Leases**

- A. HUD prefers to insure mortgages for a project owned in fee simple. For those transactions, in which fee simple ownership is not practical and a leasehold estate is proposed, the leasehold estate must be marketable. The underwriting and valuation guidance in this section applies. The MAP Lender's underwriting and appraisal analysis must fully describe the interest in a lease transaction and related values.

HUD will consider a leasehold estate consisting of land and improvements. Changes to the standard lease form addendum will only be considered where the owner/lessor is a public/government entity.

1. When used in this section, the words and terms below are defined as follows: Fee Simple Estate. Represents the entire ownership, from beneath the soil to the air above, enduring by inheritance and indefinitely into the future, typically subject to taxation and eminent domain.
2. Leasehold Estate. The interest of the lessee under a lease for a term of years. When the term of

the lease expires, all rights to possession and use revert back to the lessor/fee simple owner and the leasehold estate terminates. A leasehold estate can involve both land only or land and improvements.

3. Lessee. Tenant and typically the single asset mortgagor entity or upper tier owner of the single asset entity.
4. Lessor. Owner of the ground and of improvements. Repays lease payments. May or may not have Identity of interest with the lessee, and may or may not be an obligor under the regulatory agreement.
5. Leased Fee. The interest of the lessor/fee simple owner during the period when the project is under lease.
6. Lease. Written contract between an owner (the lessor) and a resident (the lessee) with the conditions under which the lessor will transfer the use of real project to the lessee in return for lease payments or rent.
7. Ground Lease. A long term agreement by which an owner of land (lessor) leases an unimproved, site to a lessee for a term of years.
8. Ground Rent. Payments on a ground lease and must bear a reasonable relationship to the value of the site "As Is" (before construction of on-site or off-site improvements) unless the ground lease is from a governmental agency which has made the ground lease available for a lower ground rent to support the development of affordable housing.
9. Leasehold Improvements. Improvements or additions to leased project that have been made by the lessee.
10. Gross Collections (or effective gross income). The annual amount collected from all sources, less refunds.
11. Operating Expenses (residential and commercial). Include items in accord with Generally Accepted Accounting Principles except to the extent modified by HUD program guidance. Operating expenses must include the annual amounts deposited to the Reserve for Replacement. Operating expenses shall not include interest charges, or charges or allowances for depreciation of real or personal project, or amortization of financing expense, or payments to any officer or director of the corporation, unless such payments are for services at the project which are necessary to the operation of the project.
12. Taxes. Project taxes and special assessments. Taxes shall not include income taxes. Net income before debt service payments shall mean the annual amount which remains after operating expenses and taxes are subtracted from effective gross income.
13. Debt service payments. The annual amounts paid to mortgage principal, interest, and MIP.

14. Net cash flow. The annual amount remaining after debt service payments are subtracted from net income.

B. Lease Requirements.

1. Lease Term. Lease periods are statutory. No deviations of any kind are permitted. No waivers will be granted.
  - a. For Section 220 and Section 221(d), the term must be (1) for not less than 99 years which is renewable, or (2) under a lease having a period of not less than ten years to run beyond the maturity date of the mortgage.
  - b. For Section 207/223(f) and Section 231, the lease term must satisfy one of the following requirements; (1) a lease term for not less than 99 years which is renewable, or (2) a lease having a period of not less than 50 years to run from the date the mortgage is executed.

Note: When a lease is on trust/other land on a reservation, the HUD closing attorney must ensure that the lease provisions are coordinated with Bureau of Indian Affairs requirements.

2. Legal Review. The ground lease must receive both a legal and a lender underwriting review, neither of which may be substituted for the other. HUD's legal review shall establish that the proposed lease is in conformity with the applicable statute, regulations, Form HUD-92070M (the Lease Addendum model form), and applicable provisions of local law. Except as provided in this section, any deviations from Form HUD-92070M must be approved by Headquarters' Office of Multifamily Housing Production and supported by a complete underwriting analysis by the lender and reviewed by the HUD field office recommending approval. Local Counsel must approve: (1) the legal need for any proposed lease term changes, and (2) that any term changes are consistent with the following requirements of the Section of the Act under which the project is underwritten. This documentation is necessary when referring requested changes to HQ. Exceptions from the need for HQ approval are as follows:

- a. The Regional Center Director may waive the right of the Secretary to purchase the fee in the event of default only in cases where the lessor is a public entity or housing authority.
- b. The Regional Center Director may approve the modification of the lease addendum only in cases where the land and/or the land and improvements are to be leased from a public entity or housing authority and the project is affordable as defined in Section 3.1.L. or be a low leverage, low risk loan with significant public purpose benefit. (Market rate projects are not eligible). In these cases, the lease addendum shall conform to the instructions set forth below:
  - 1) The second paragraph of the document (immediately above "LEASE ADDENDUM") may be stricken from the document, provided the lease is otherwise eligible for use in the FHA multifamily mortgage insurance programs under the National Housing Act, i.e., it is a mortgageable real project interest under state law and conforms to the statutory requirements for duration.

- 2) The first paragraph of the document, under “INSTRUCTIONS FOR LEASEHOLD PROJECTS”, is still applicable in this context and may not be deleted.
- 3) Certain definitions in the form must be revised to accurately describe the entirety of the project making up the leasehold estate. Namely, the definition of “Improvements” should be stricken, along with any additional use of this word when referencing this formerly defined term.
- 4) A definition of “Project” must be included, as well as amended from the current definition to include the land, buildings and improvements (and fixtures), so that “Project” is defined “as the legally described land, in addition to all buildings, fixtures, structures, alterations or other improvements and fixtures now constructed or at any time in the future constructed or placed upon the land, including any future replacements and additions hereafter located thereon.” This revised definition of “Project” should be included as a footnote to the first use of the word in the first paragraph under “LEASE ADDENDUM”.
- 5) Any reference to “ground” (when immediately preceding “lease”) throughout the document may be stricken, so that the document refers to a “lease” and not a “ground lease.”

c. **Air Rights.** For projects involving air rights, local counsel may modify the addendum as necessary to account for this form of ownership.

- C. Option Price for the Federal Housing Commissioner. The ground lease must contain an option for the Federal Housing Commissioner to buy out the lease. The option price contained in the lease addendum must reflect the value of the leased fee in Form HUD-92264 in effect at the time of Firm Commitment.
- D. Regulation for Leaseholds. HUD regulations state “Reduced mortgage amount - leaseholds. In the event the mortgage is secured by a leasehold estate rather than a fee simple estate, the value or replacement cost of the project described in the mortgage shall be the value or replacement cost of the leasehold estate (as determined by HUD) which shall in all cases be less than the value or replacement cost of the land as project in fee simple.”
- E. Unacceptable Lease Payments. Some variable lease payments may not be acceptable because they raise the risk that future payments may be too burdensome and may cause a potential default in the mortgage payments. Examples of unacceptable methods of determining variable ground rents are: a graduated schedule of future increases on a lump sum year-by-year basis, Cost of Living Allowance (COLA) or Consumer Price Index (CPI) increases, and increases based on the results of future appraisals or arbitration.
- F. Acceptability of Lease Payments. To determine if the initial amounts are within underwriting limitations, ground rents may be computed using any of the following three methods:

- a. A fixed percentage of gross collections (or effective gross income). The percentage must remain the same throughout the term of the lease.
- b. A fixed percentage of net cash flow to equity (after debt service payments but before lease payments). The percentage must remain the same throughout the term of the lease.
- c. A stated dollar amount per year which must remain fixed for at least ten years more than the term of the insured mortgage. (If monthly or quarterly payments are required, these will be converted to annual amounts by the appraiser). When the lease contains more than one method of computing lease payments, it must also indicate whether the amount to be paid is to be the greatest or the least, or the sum of these amounts. The stated annual dollar amount may be described as a minimum payment.
- d. The MAP appraiser must estimate the lease payments, using the lump sum annual amounts and percentages contained in the lease provisions, as applied to the estimated annual effective gross income or annual cash flow indicated by the appraisal and on Form HUD-92264. (The estimates are not based on the income which would be available during any period of deficit operation, but must reflect the effective gross income shown on Form HUD-92264 and the corresponding cash flow to equity which result when sustaining occupancy has been reached.).

G. Valuation Instructions.

1. **For projects that involve a ground lease without an option to buy**, the Department will not insure a loan that will recognize a leasehold interest for security unless the property meets the requirements of paragraph 3 below. For this reason, the value of the site “as is” will be entered by the MAP Underwriter on lines 3.b.(1) and 4.f on the form HUD 92264-A named “Value of the Leased Fee”. This is to be done regardless of whether the ground rent is an escalating amount based on a percentage of gross collections or cash flow, or whether it is a level stated dollar amount each year.

**NOTE:** These instructions are included only for underwriting and loan sizing purposes. The actual value of the leased fee is estimated by capitalization of the ground rent in section K-6 on the form HUD 92264.

2. **For projects involving a ground lease with an option to buy**, the value of the leased fee may be estimated by capitalizing the ground rent. The following conditions apply:
  - a. The lease must give the lessee an option to buy the site in fee simple for a stated purchase price at some time during the term of the lease.
  - b. This stated purchase price must be provided in the ground lease and may not exceed the value of the fee estimated by the capitalization method of value at the time of project appraisal.
  - c. The annual ground rent required by the lease must be level payments of a stated dollar amount and must remain unchanged from the date of mortgage endorsement to at least ten years after the mortgage term.

3. **For affordable projects involving a lease on both land and improvements with an option to buy.** In addition to G.2 (above), the following requirements apply:
  - a. The lessor must be a non-profit entity.
  - b. The project must meet the affordability requirements set forth in 7.15.G.4.b.below, as well as the underwriting requirements set forth in 7.15.g.4.c-g, below.
  - c. No deviations from form HUD-92070M are permitted, except for those previously stated in B.2.b (above).
  
4. **For affordable projects involving a lease on land, or on both land and improvements:**
  - a. The lessor must be a governmental body or housing authority. There are no exceptions and no waivers at the Regional Center level.
  - b. The project must:
    1. Qualify as affordable housing, as defined in Section 3.1.L; or
    2. Be a low leverage, low risk loan with significant public purpose benefit.
  - c. The project interests to be appraised are “fee simple” and “leased fee.”
  - d. There must be a thorough discussion in the appraisal and underwriting narrative regarding the lease terms and a determination that the leasehold estate is marketable.
  - e. The fee simple determination must be made based in compliance with the current MAP Guide
  - f. The Department will permit the use of Discounted Cash Flow analysis and/or Direct Capitalization of the or in determining the value of the leased fee. There must be a thorough discussion of the parameters used and how the discount rate was derived.
  - g. The value of the leasehold will be accounted for on the form
  - h. HUD 92264A by subtracting the value of the leased fee as appropriate in Criteria 3, and 4.
  
5. **Ground Leased from Public Bodies.** On sites leased by a governmental body to a developer for use for a specific purpose, the procedures outlined in this chapter remain unchanged, except that the "As Is" market value of the site, vacant or improved, in fee simple may not exceed the value of the leased fee.
  
6. **Rehabilitation of an Existing Leasehold Project (Leasehold Improvements owned by the mortgagor).** When a leasehold estate contains existing buildings and is to receive an insured mortgage for substantial rehabilitation, valuation processing will vary from fee simple rehabilitation processing as follows:
  - a. Tentative "As Is" value of both land and building(s) must be established by capitalization of income and by comparable sales. The Cost Approach may be used where buildings are in extremely poor condition and/or vacant.

- b. Value of the land without building improvements must be made by market comparison based on sales of similar sites.
- c. Acquisition Cost of Buildings. Since the value of the land without improvements does not include buildings, the cost of the acquisition of the buildings will be whatever added cash amount the buyer pays the seller of the subject project for the buildings, net of land, at or before initial closing. A certificate of the separately agreed amount for purchase of the buildings must be submitted with the application exhibits. In a refinancing loan which does not involve a buyer and seller, the cost of the buildings may not exceed the remaining mortgage balance.
- d. Final “As Is” value of entire project is the lesser of Tentative “As Is” Value or the sum of Value of Land without Building Improvements and Acquisition Cost of Buildings. Value of the Leased Fee is considered to be the Value of Land without Building Improvements. The value of the leased fee must be estimated to equal the value of the site in fee without the on-site improvements and is entered on Line K-6 of Form HUD-92264.

H. Other Provisions:

- 1. **Ground Rent during Construction.** For proposed construction under all FHA insurance programs, lease payments during construction must be included in the estimated replacement cost of the project and in the certified cost, subject to the following conditions:
  - a. The period for which ground rent is estimated must be the same as that for which interest and other related charges are calculated, or, the estimated construction time plus two months.
  - b. Ground rent during construction must be entered in Line G 69 of Form HUD-92264 (currently labeled “Construction Fee.”). A remark must be entered in Section H, indicating that the amount in Line G 69 represents Ground Rent during Construction.
  - c. Ground rent must not be included in the base on which Section 220, 221(d) BSPRA is calculated.
  - d. The annual amount of ground rent during construction may not exceed the test for acceptability of lease payments.
  - e. For rehabilitation under all Sections of the Act, ground rent during rehabilitation must be included in the replacement cost.

## 7.16 Tax Abatement Procedures

- A. General Comments and Exceptions. Tax Abatement is a reduction of project taxes for a specified term by the taxing authority. Properties with abatement are eligible for additional mortgage funds under certain circumstances. The abatement must run with the real estate and not with the type of sponsorship if it is to secure additional mortgage proceeds based upon value (Criterion 3). The debt

service approach (Criterion 5) used for underwriting must include an amount for the expected project taxes (including abatement or PILOT) in project operating expenses. The terms of the tax abatement must be analyzed and a stress test demonstrating the risk must be performed even if the present owner or its transferee may benefit from the abatement for the term of the mortgage. The risk that a transferee of the project or an assignee of the mortgage in the future might cause the tax abatement to be lost is an unacceptable risk to the insurance fund. Exceptions to these requirements include the following:

1. If the financing includes LIHTC equity and if the tax abatement runs with the sponsorship (borrower) entity, then the Regional Center Director may waive the MAP Guide so that the underwriting does not have to include a provision for project taxes during the period of the tax abatement. This exception is justified for low loan-to-value mortgages on LIHTC projects and the additional due diligence and oversight by private equity investors.
  2. Properties leased from a governmental body to either a non-profit or for-profit developer, where the project is exempt from taxes and the abatement flows to the leasehold improvements. There is usually a requirement for a percentage of units to be set aside as affordable housing which is imposed by a land use restriction or regulatory agreement. Regional Center Directors may grant a waiver, after appropriate review, to promote affordable housing.
- B. Long Term Tax Abatement. If the amount of the tax abatement is fixed and runs the entire term of the mortgage, the real estate tax expense reported on the HUD-92264 must be the actual amount of taxes the project will pay, if any. The full amount of the real estate taxes without the abatement must be noted in the remarks section of the HUD-92264. The project will benefit from an increased mortgage amount due to the lower pro-forma operating expenses and an increased NOI estimate. When the abatement runs for the full term of the mortgage, the NOI used for Form HUD-92264-A Criteria 5 may also be processed at the reduced tax amount. Also, if value attributable to long term tax abatement is recognized in the subject's market area, the same NOI may be capitalized and the resulting value may be used in Criterion 3.
- C. Short Term or Variable Tax Abatement. If the abatement is short term or variable, it may still be used to secure additional mortgage proceeds. The additional mortgage will be the amount that will amortize over the term of the tax abatement. A special amortization plan must be requested which has debt service payments that are increased by the additional net income generated during the term of the abatement. When processing a short term or variable abatement, the full amount of the project taxes must be estimated and included in the total project expenses on Form HUD-92264 as if there were no abatement. The additional debt service carry resulting from the abatement must be calculated on line I, Criteria 5 of HUD-92264-A.

If Criteria 5, "Amount Based on Debt Service Ratio" is not the controlling criterion, short term or variable abatements cannot be used to secure additional mortgage proceeds. Also, the appraiser must not include extra value associated with short-term abatement in either the estimate of land value, the

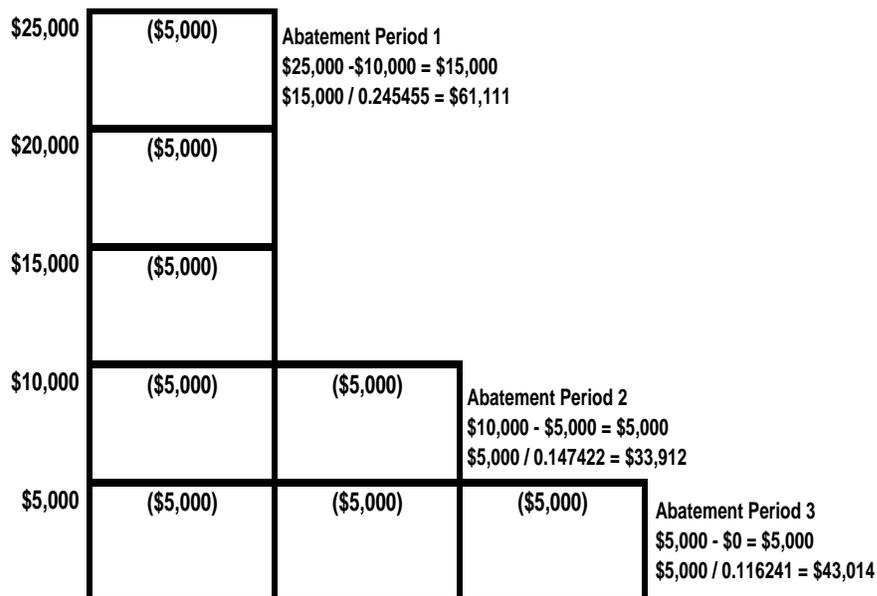
“As Is” value for substantial rehabilitation or the “As Repaired” value for existing projects, and it may not be included in Criterion 3.

1. Short Term Abatements: Assume that Project A has been awarded a 5-year tax abatement of \$5,000/year and the interest rate on the insured loan is quoted at 7.5% and the MIP is 0.5%. The amount of additional mortgage is calculated by dividing the annual abatement, \$5,000 by the applicable debt service constant (P, I, and MIP). In this example the debt service constant is 0.245455383.

$$\$5,000 / .245455383 = \$20,370$$

Additional mortgage amount. The mortgage amount based upon debt service (Criteria 5 of HUD-92264-A) would be increased by \$20,370 and a special amortization schedule would be required with a debt service payment that is \$5,000/year greater in years 1 through 5.

2. Variable Abatements: Variable tax abatements are more complex to quantify, but are essentially calculated in the same manner. Assume that Project B has been awarded 15-year tax abatement. In years 1 through 5, the abatement is \$25,000; in years 6 through 10 the abatement is \$10,000; and in years 11 through 15 the abated amount is \$5,000. The interest rate on the insured loan is quoted at 7.5% and the MIP is .5%. The amount of additional mortgage is calculated as the amount that could be fully amortized by the variable payments over the 15-year period based on the stated financing terms. The graph below illustrates the calculation.



When there are two or more abatement amounts and periods, and the amounts decline, the abatement amount for each period is found by subtracting the abatement amount of the next period. Period 1 will run for 5 years, Period 2 will run for 10 years, and Period 3 will run for 15 years. Because all three periods begin amortization at the same point in year 0, the amount of the abatement for the next period must be subtracted to avoid double counting.

1) Abatement Period 1

\$25,000 minus \$10,000 (the amount of abatement in period 2) = \$15,000 for 5 years. The debt service constant for a 5 year term at 7.5% interest with 5% MIP is 0.245455383. Dividing \$15,000 by 0.245455383 indicates additional mortgage proceeds of \$61,111 attributable to period 1.

2) Abatement Period 2

\$10,000 minus \$5,000 (the amount of abatement in period 3) = \$5,000 for 10 years. The debt service constant for a 10 year term at 7.5% interest with 0.5% MIP is 0.147442123. Dividing \$5,000 by 0.147442123 indicates additional mortgage proceeds of \$33,912 attributable to period 2.

3) Abatement Period 3

\$5,000 minus \$0 (since there are no periods remaining) = \$5,000 for 15 years. The debt service constant for a 15 year term at 7.5% interest with 0.5% MIP is 0.116241483. Dividing \$5,000 by 0.116241483 indicates additional mortgage proceeds of \$43,014 attributable to period 3.

4) Adding the supportable mortgages from each of the abatement periods results in a total additional supportable mortgage of:

Period 1 = \$ 61,111  
Period 2 = \$ 33,912  
Period 3 = \$ 43,014  
Total = \$138,037

The mortgage amount based on debt service, (Criteria 5 of HUD 92264-A) would be increased by \$138,037 and a special amortization schedule would be required with a debt service payment that reflects \$25,000 per year in years 1 through 5, \$10,000 per year in years 6 through 10, and \$5,000 per year in years 11 through 15.

## 7.17 Project Based Section 8 and LIHTC Processing

- A. For Section 223(f). The project must be evaluated under two scenarios: a) the “hypothetical market value” of the project without regard to any Section 8 project based subsidies, rent restrictions or LIHTC; and b) a debt service analysis that considers all Section 8 project based subsidies and other low income rent restrictions must be performed. Two independent Section C rent schedules must be prepared, one for a hypothetical market rent estimate and one that recognizes all rent restrictions and subsidies.

1. Criteria 3 Market Value: The appraiser must ignore the Section 8 contract rents, tax exempt bond or LIHTC restricted rents when determining market value and the income to be capitalized for a determination of market value for the purposes of determining Section K, Form HUD-92264, and Criteria 3 Form HUD-92264-A Value. To be consistent, the appraiser must use a market capitalization rate and must assume market rents in the income approach to value. Note that the comparable sales approach to value must be completed without regard to Section 8 or LIHTC awards.
  
2. Criteria 5 Debt Service Analysis: In calculating net operating income to be used for Criteria 5 Debt Service, rent restrictions must be observed. For the Criteria 5 debt service analysis, the Line 6, Form HUD-92264-T rents must be used. This applies to projects receiving LIHTCs that may use either tax exempt bond or market-rate financing.
  
3. Form HUD-92264T for LIHTC projects without Section 8: Follow existing form instructions. Processing will be based upon the lesser of Lines 1, 4 or 5.
  
4. Form HUD-92264T for Section 8 Project Based Assistance without LIHTC:
  - a. Enter the market rent by comparison on Line 1
  - b. Enter Personal Benefit Expenses on Line 2
  - c. Line 3 is Not Applicable
  - d. Line 4 is Not Applicable
  - e. Enter the Project Based Section 8 Contract Rent on Line 5
  - f. Subtract Line 2 from Line 5 (if applicable)
  - g. Process using the lesser of Line 1 or Line 5
  
5. Form HUD-92264T for Section 8 Project Based Assistance with LIHTC:

The LIHTC rent must be recorded but is not used as a limiting criterion because the total income to the project is the LIHTC rent combined with the Section 8 rent, so that the actual amount of rental income to the project will be the Project Based Section 8 rent, as follows:

2 Bedroom Section 8 Contract Rent	\$850/Month
2 Bedroom LIHTC Rent limit	\$350/Month

Resident's Rent Obligation to Project:	\$350/Month
Section 8 Payment to Project:	\$500/Month
Total Income to Project	\$850/Month

B. Fee Income. If additional fees for project amenities are mandatory for all residents, the mandatory fee income from restricted units must be excluded from the calculation of net income. The mandatory fee income from non-restricted units may be included if these amenity fees are indicated by comparable properties in the market and it must be explained in the remarks section of Form HUD-92264.

C. Expenses/Fees. Properties with LIHTC restricted units will commonly have a higher operating expense ratio per unit than market rate properties, which may be due to increased administrative costs for tax credit compliance monitoring, performing resident income certifications and staffing to provide on-site resident services. Estimating operating expenses for projects that are to be funded through the sale of LIHTC, requires the analysis of LIHTC comparables if available, and consultation with other experts (i.e. appraisers and project managers) in the context of current market conditions which should consider the size of the project and unit mix. Utility expense unit rent adjustments in LIHTC projects may be estimated by the analysis of actual costs supplied by the developer, the utility company or by use of the Section 8 utility allowances.

1. If the project has the same operating expenses under LIHTC or Project Based Section 8 operation as it would under market rate operation, enter expenses as usual.
2. If a project has different expense needs as a subsidized project, the expenses used for Criteria 3 must be market rate expenses and the expenses used for Criteria 5 debt service shall be the actual expenses under its' proposed usage. This will insure that the Criteria 5 - debt service analysis of the HUD 92264a is calculated based on the actual estimate of the rent restricted NOI for the project.
3. Audit Fee no Longer Recognized. With the elimination of the requirement for an audited cost certification for mortgage insurance transactions with LIHTC, assuming the ratio of loan proceeds to the actual cost of the project is less than 80 percent, the audit fee will no longer be recognized as an allowable cost in the Total Estimated Replacement Cost of Project, Section G line 66 Form HUD-92264.
4. A real estate tax abatement will be recognized in both value (Criterion 3) and underwriting (Criterion 5) calculations even if the abatement runs with the owner rather than with the land, so long as the owner is non-profit sponsored.

D. Sections 220 and 221(d) Site Value and "As Is" Value.

The site value of land in new construction or the "As Is" value in substantial rehabilitation cases is to be estimated using a capitalization rate and project NOI as if the units and the project were unrestricted and market rate, without considering: a) any additional value that may be attributable to subsidies available to the project or any LIHTCs or other tax benefits the project will receive, or b) any value

reduction due to any NOI or value limitations caused by regulatory agreements or affordability restrictions imposed by any subsidy program or tax regulation. This valuation methodology permits sponsors to acquire project at its market value for new construction or rehabilitation of affordable housing. The value attributable to the presence of LIHTCs diminishes over time and is not always freely transferable, and thus should not be taken into consideration.

**NOTE:** Cost Certification instructions (enforced by Statute) dictate that the **lesser** of the “as is” value of the land and improvements (before repair or rehabilitation) **or** the purchase price of the land and improvements, is used in the cost build up for Criterion 3 of form HUD 92264A, in substantial rehabilitation cases. Consequently when mortgage proceeds will be used to fund the acquisition of the project, the “as is” value estimation will be used as a test of the reasonableness of the acquisition price.

When the acquisition price is less than the “as is” value of the land and improvements (as accepted by HUD), and mortgage proceeds will be used to fund the acquisition of the project, the acquisition price will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment

When the acquisition price exceeds the “as is” value of the land and improvements (as accepted by HUD), then the acquisition price must be reduced to the “as is” value and will, subsequently, comprise the basis of the cost build up for the Firm Commitment.

When mortgage proceeds will **not** be used to fund the acquisition of the project, the “as is” market value of the project will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment. This is particularly significant when below market rent restrictions, (such as in the case of LIHTC limited rents or Section 8 rent subsidy) are in place and the use of market rents in valuing the project will result in a premium over these rent restrictions. Income Limits. The HERA must ascertain that the correct income limits are employed in calculating the maximum LIHTC rents and in completing Form HUD-92264-T. HERA modified HUD’s income limit methodology for calendar years after 2008 to require HUD to increase applicable area median incomes by the amount area median incomes rise, even if the HUD- determined area median incomes would be frozen under HUD’s 2007 and 2008 income limit methodology.

## 7.18 Appraisal Review Policy and Requirements

### A. Scope of Work.

1. Scope of Work includes project identification, extent of inspection, the type and extent of data researched and the kind of analysis needed to arrive at opinions or conclusions. The rule also states that appraisers have broad flexibility and significant responsibility in determining the appropriate scope of work for an appraisal or appraisal review assignment.
2. According to USPAP, appraisers, including HRAs are responsible for determining the scope of work. However as an employer who is also the client, the Department may issue guidance as to what is the extent of an assignment for a review appraisal. It is not a violation of USPAP for an appraiser to accept an assignment, in which a limited scope of work is appropriate, so long as the assignment and scope of work are clearly defined, produces credible results and is performed objectively without bias.
3. HRAs may have to expand the scope of work and do additional research in performing an

assignment. The HRA should discuss such situations with management in order to determine whether additional work by HUD staff is appropriate, or if the application should be rejected or approved with conditions.

4. According to USPAP, if relevant information is not available because of assignment conditions that limit research opportunities (such as conditions that place limitations on inspection or information gathering), an appraiser must withdraw from the assignment unless the appraiser can still develop credible assignment results. For example, they may be able to modify the assignment conditions to expand the scope of work to include gathering the information, or use an extraordinary assumption.

#### B. Jurisdictional Exception Rule.

1. The Jurisdictional Exception Rule provides a saving or severability clause intended to preserve the balance of USPAP if compliance with one or more of its parts is precluded by the law or regulation of a jurisdiction. When an appraiser properly follows this Rule in disregarding a part of USPAP, there is no violation of USPAP.
2. USPAP defines law as including constitutions, legislative and court-made law, administrative rules and ordinances. Regulations include rules or orders having legal force, issued by an administrative agency, such as HUD. This would include Handbooks, Notices, and the MAP Guide. Instructions from an attorney or a client do not establish a jurisdictional exception.
3. The need to take a Jurisdictional Exception should be rare. If it is needed, the appraiser or HRA must specifically cite the regulation and the portion of USPAP that is affected. Verbal direction from management is not sufficient to justify an exception. The HRA must cite a citation from the MAP Guide or other appropriate authority.

- C. Record Keeping Rule. This rule specifies record keeping procedures for appraisers. The rule does not mandate that an appraiser have possession of assignment work-files. The Department does not permit permanent or personal possession of records relating to a review appraiser's work. The Department retains these records for far more than the time required under USPAP and will, with due process of law, cooperate with appraiser regulatory agencies, professional peer review committees, and to assist obtaining a professional designation. Appraiser work-files will be maintained in the Satellite office. When an HRA leaves employment they shall be transferred to the Regional Office. Records should be stored on the local or regional network drive. Paper records should be scanned as needed.

- D. Loan Committee. HRAs are expected to complete workload assignments to facilitate loan approval (or rejection) including an executive summary and other material needed for Regional Center or National Loan Committees. The summary is intended to allow peers and management the ability to efficiently complete their reviews and conclusions. The Department allows the use of an alternative format for the NLC narrative as long as it is approved by the Regional Center Director and contains an executive summary. It is the Department's position that its programs and instructions are in compliance with USPAP. Management has the right to disagree with conclusions made by HRAs or any other technicians. Management should document the file with the reasons for any disagreement. The original conclusions are part of the permanent project file.
- E. Workload Sharing. Workload Sharing arrangements may require HRAs to perform reviews without the benefit of being able to do a physical inspection. The assignment will generally be completed with the HRA making certain assumptions, such as the condition to be consistent with the photographs and other reports.
- F. Consultations with other staff. HRAs may be required to provide consultation with senior underwriters and other staff who have been asked to review an appraisal. A Frequently Asked Questions grid included in Addendum 7 that discusses tasks which can be accomplished, as well as the level of required USPAP compliance.
- G. Environmental Processing. The responsibility for environmental processing has been typically assigned to the HRA, though other appropriately trained HUD staff may also perform these reviews. Federal regulations (24 CFR 50.11 and 50.32) require that a HUD approving official make an independent evaluation of the environmental issues, take responsibility for the scope and content of the compliance finding, EA or EIS, and make the environmental finding. This function cannot be delegated to a lender or the lender's or owner's consultants. The HRA staff appraiser or other environmental reviewer can and should be provided with information from the lender or the lender's consultant, however, the function must be performed by HUD staff.

When HUD staff appraisers are assigned this duty, it is not considered an appraisal assignment subject to USPAP requirements. The Department expects the appraiser or other responsible staff to ensure compliance with Wetlands/Flood Plain Executive Orders, Fish and Wildlife, Historic Preservation, etc., and to obtain such information as needed from other governmental or private sources, based on review of the lender prepared Phase I Report and preparation of any required documentation. It should be noted that the Department has consulted with the Appraisal Foundation and has concluded that the obtaining of such information by the HRA is not advocating for the client and USPAP does not apply.

- H. Technical Appraisal Review Requirements. The HRA or senior underwriter must follow the review requirements listed below:

1. Exhibits. The lender must submit the exhibits listed in Section 7.10.A to HUD.
  2. Market Study Review. The HRA or senior underwriter and the EMAD economist must each provide a desk review of the market study to determine reasonableness and compliance with Market Study requirements. The Reviewer must make final recommendations to the team leader regarding market demand for the project.
  3. Level of Inspection. The HRA or senior underwriter must state the level of inspection. Preferably they should inspect the subject site and as many as possible of the comparables used in the appraiser's forms HUD-92273 and HUD-92274 analysis.
  4. Environmental Review. The HRA (or other designated employees) must review the Phase I ESA, and prepare any required documentation.
  5. The HRA must review site characteristics and make a recommendation regarding site acceptability to the team leader.
  6. The HRA must determine that the comparables submitted are acceptable.
  7. From a review of Forms HUD-92264, HUD-92273, HUD-92274, and supporting information, the HRA must make a recommendation to the team leader regarding:
    - a. The acceptability of the proposed rents and estimated rental income.
    - b. The acceptability of the total operating expenses.
    - c. The acceptability of the site and the estimated warranted price of land or "as is" value.
    - d. If applicable, the estimate of market value.
    - e. Any recommended modifications necessary to approve the application instead of a categorical rejection. Any value conclusions made by HRA that differ from the appraisal under review require preparation of a work file in accordance with Standard 1 of USPAP. Only licensed appraisers may develop a different value. In determining acceptability, the Department prefers that the HRA or senior underwriter only opine on the quality of the work under review and as to whether or not it is reliable for use in underwriting mortgage insurance.
  8. Compliance with USPAP. The HRA or senior underwriter must also ascertain if the appraisal complies with Standards 1 and 2 of the Current USPAP. Senior underwriters must be familiar with USPAP or consult as necessary with the HRA. USPAP does not require that reviews to determine USPAP compliance be made by an appraiser.
- I. Documentation of the Appraisal Review. The Department's SharePoint site contains a number of appraisal review templates as well as review forms from the previous MAP Guide. HRAs and senior

underwriters have a great deal of flexibility in the format that they use, so long as it is approved by the Regional Center Director and contains an executive summary.

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## Chapter 8 Mortgage Credit

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### 8.1 Introduction

Principals of the borrowing entity and entities participating in FHA multifamily mortgage insurance programs must have a positive credit history demonstrating that they will honor their legal, financial and contractual obligations. All Principals must be identified and analyzed with respect to their capacity of credit, experience and financial histories. Regulatory standards established in the Code of Federal Regulations (24 C.F.R.) Part 200 Subpart H Participation and Compliance Requirements determine the appropriate review of previous participation in multifamily insured programs based upon their past performance as well as other aspects of their records. This chapter is designed to explain who to review and explain FHA's underwriting criteria for determining creditworthiness (positive credit history, adequate financial strength) of Principals and determining the maximum insurable mortgage and financial requirements for closing.

In many areas addressed in this chapter, separate policy has been developed for Low Income Housing Tax Credit projects and this policy is presented in Chapter 14. If apparent conflicts arise in areas addressed by both this Chapter and Chapter 14, Chapter 14 guidance should prevail in the underwriting of Tax Credit Projects.

### 8.2 Borrower Types – Single Asset Borrower Entity

A single asset borrower entity is required for all multifamily FHA mortgage insurance projects. Natural Persons, Delaware Statutory Trusts, foreign entities, and Tenants in Common are not eligible, although such entities may have ownership interests in the single asset entity borrower. Acceptable forms of single asset entities that may participate in FHA insured transactions include the following:

1. General Partnership (GP) with two or more general partners.
2. Limited Partnership (LP) with one or more general partners and one or more limited partners.
3. Corporation, C Corporation, or S Corporation with shareholder owners and corporate officers and directors who may or may not be shareholders.
4. Limited Liability Company (LLC) composed of members, with one or more managing members and one or more investor members.

5. Trust with beneficiaries and one or more trustees (when borrower is a trust the duration of the trust must be equal to or longer than the term on the FHA Note).
6. Nonprofit Corporation with officers and directors.
7. Any other public or private single asset borrower entity.
8. Any combination of acceptable ownership forms can be used to establish a joint venture for the purpose of jointly sharing the risks and the rewards by contributing the appropriate knowledge, skills or assets necessary to a successful development project. However, the borrower must always be a single asset mortgagor entity.

Generally, foreign nationals and corporate entities may participate as Principals. However, the single asset borrower entity must be registered in the United States and in the State where its corporate office is located. At least one principal with operational decision-making authority must be a United States citizen or a foreign national lawfully residing in the United States, having an immigration status granted by the United States government that would enable that person to exercise such authority.

EB-5 is a U.S. Citizenship and Immigration Services (USCIS) program that has been used to raise equity. For information on the EB-5 program please visit the U.S. Citizenship and Immigration Services (USCIS) website at <http://www.uscis.gov/eb-5>. EB-5 investments must comply with HUD requirements for funding equity, and thus cannot use a deferred pay-in schedule (such as may be used for tax credit equity proceeds.)

Structures that propose EB-5 investments as debt rather than equity are subject to the limitations on secondary financing, and only allow it within the limits specified. HUD will only consider waivers if there are significant affordable rent and income restrictions and there is some public interest motivation (beyond the EB-5 program incentive itself.)

A U.S. based developer and managing member of the project's ownership entity, must meet HUD requirements for a domestic principal/manager.

### **8.3 Reviewing Principals and Other Parties in Control**

The individuals and entities who exercise operational and financial control over a project are subject to review. This review includes underwriting review, and a review of previous participation of such individuals and entities in federal programs.

#### **A. Determining Principals and Who is in Control.**

The term Principal in this MAP Guide refers to individuals and entities that exercise operational and financial control over a project. MAP Underwriters consider Principals in three contexts: (1) individuals or entities which must be disclosed for Previous Participation review; (2) persons or entities required to execute Section 50 of the HUD Regulatory Agreement; and (3) individuals or entities which possess financial and/or legal control of the borrower, thereby requiring full or limited financial and credit analyses.

“Principals” are defined as:

1. “Active Principals” are individuals or entities who singly or with others, direct and control the Borrower and are responsible for the Borrower’s ability to execute any and all actions for the benefit of the project, regardless of the extent of their equity interest.
2. “Passive Principals” are persons or entities who singly or with others have limited or no decision-making power or control over the Borrower but who have an ownership interest of 25% or more (10% for corporations) in the Borrower.
3. “Borrower” is the single asset entity mortgagor.

A Principal may be a public or private entity, an individual or business entity proposing to participate in a project as an owner or general contractor. A Principal maintains significant decision-making authority regarding an FHA-insured loan transaction, and/or retains a significant percentage of ownership in a single asset borrower entity. The Principal’s role can involve active participation in directing the activities and affairs of the borrower entity or passive participation when an ownership interest has been acquired in the entity. All types of Principals are subject to financial and credit disclosure and underwriting.

#### B. Underwriting Principals and Those with Control of a Project.

1. Principals must have positive experience and qualifications in developing, owning or building multifamily properties reasonably comparable in kind and scale to the subject of the proposed transaction. Comparable in kind and scale means: (a) similar in physical size (e.g. number of units) and building type and uses (e.g., low rise, high rise, commercial spaces); (b) similar financially (e.g. revenues, expenses, size of mortgage, required liquidity); (c) similar operationally (e.g. target markets/tenant population, elderly, subsidized or affordable); and (d) similar in kind of transaction purpose (e.g. acquisition, re-positioning/turn-around, rehabilitation, new construction). Underwriting a Principal requires their financial and credit disclosure, including: (1) a designated person to sign Section 50 of the Regulatory Agreement, (2) individual or entity credit reports, (3) individual or entity financial statements, HUD forms, documents and Schedule of Real Estate Owned (REO)/debt schedules, (4) Internet searches and searches of debarment, OFAC (Office of Foreign Assets Control) and any other relevant databases, and (5) pre-approval in cases where their total HUD-insured debt is greater than \$250,000,000.

Active principals of a borrowing entity with less than a 25% ownership interest (10% for corporations) but possessing a substantial financial interest and/or having decision making authority are subject to underwriting review.

2. Other Principals (individuals and entities) must be reviewed for underwriting purposes:
  - a. Investors that have exceeded the \$250,000,000 million threshold or wish to avoid exceeding that threshold and wish to invest in a project as a passive investor with less than a 25% interest

(10% for corporations).

- b. An investor qualifying as a key financial partner from both a financial strength standpoint and cash requirement contribution but still maintains an ownership interest of less than 25% (10% for corporations).

3. Principals not subject to credit review:

- a. Investor entities with limited liability benefiting from tax credits, including but not limited to low-income housing tax credits pursuant to Section 42 of Title 26 of the United States Code, whether such investors are syndicators, direct investors or investors in such syndicators and/or investors.
- b. Parties whose sole interest is that of a purchaser or owner of less than five individual unit(s) in the same condominium or cooperative development; (ii) parties whose sole interest is that of a tenant in not more than two units in an FHA mortgaged insured property.
- c. Public Housing Agencies (PHAs) where the PHA is acting in its capacity as a PHA owning and/or operating public housing. However, PHAs are expected to form single asset entities to hold properties financed with FHA mortgage insurance.
- d. Passive Principals who have limited or no decision making power or control over the ownership entity. A passive Principal's financial or other obligations to the borrower and the property may be fixed and defined before endorsement, with the borrower or its Principals having limited or no power to compel a passive Principal to increase its obligations. A passive Principal may have limited power singly or with others, or no power to remove, replace or diminish the powers, or alter the compensation of Principals. As used here "limited" means that the rights of a passive Principal to exert control or effect decisions that are defined in organizational documents and are limited to specific actions intended to remedy negligence or default by a Principal, or to protect the passive Principal from loss due to a default or failure of performance by the borrower.

C. Regulatory and Processing Requirements for Previous Participation Review.

Certain Principals are subject to a previous participation review as set forth in 24 C.F.R. Part 200, as the same may be amended from time to time. This review is in addition to any underwriting considerations or review. Those individuals and entities subject to previous participation review in accordance with 24 C.F.R. Part 200 must submit form HUD-2530 or any succession form or electronically through the Active Partners Performance System (APPS) or any successor electronic system. Individuals and entities that are excluded from underwriting review are also excluded from previous participation review. Guidance with respect to previous participation review may be updated from time to time through Mortgagee Letters or other appropriate guidance means.

1. For any multifamily project financed or proposed to be financed with an FHA insured mortgage under the National Housing Act, an individual or entity serving in any of the following capacities is also considered to be a "Participant" for purposes of this chapter. Participants are persons or

entities who may or may not be an Active or Passive Principal but who are required to file for previous participation review, e.g. Form HUD-2530 or APPS:

- a. A borrower;
- b. An owner, if different than borrower, e.g. in a transfer of physical assets (TPA) or change in role;
- c. A management agent; and/or
- d. A general contractor.

In addition to the entities named above, an individual or entity determined by HUD to have control over the financial or operational decisions of an FHA-insured property shall also make a Previous Participation Review Submission.

The previous participation certification procedure assesses the experience of applicants with FHA-HUD insured mortgage programs and with the United States Department of Agriculture Rural Development (USDA-RD) multifamily programs. All submissions must include a Previous Participation Certification and may be made via the Active Partners Performance System (APPS), or a paper Form HUD-2530 . They are responsible for its timely filing with the local HUD office with jurisdiction over the project application or proposal. Previous Participation Review or Form HUD-2530 is not a substitute for processing the application for project acceptability, credit capacity, or competency. Paper submissions are acceptable if the Participants are having trouble with the APPS access. All Participants must certify and sign the certificate personally as to their individual record and are responsible for its timely filing with the Regional Center having jurisdiction over the project. Any Participant experiencing trouble with or want to learn more about APPS, get registered, access the user guide and use the tutorial should visit HUD's website at: <http://www.hud.gov/offices/hsg/mfh/apps/appsmfhm.cfm>.

2. Certifications are required from the following:
  - a. Tax credit syndicators or investors with an identity of interest in the general partner.
  - b. For-profit entities; officers of the entity's board of directors (BOD); officers and the executive management team of the entity (such as the President, Chief Executive Officer etc.), if different that the officers of the BOD; or any other individuals determined by HUD to control the entity.
  - c. Nonprofit borrowing entities and its officers and executive management team (if different).
  - d. A previous participation certification (through either a form HUD-2530 or APPS) is not required on the following situations or roles:
    - 1) Individuals who provide a certification in one capacity need not provide a separate duplicate certification;

When a corporation (for-profit or nonprofit) is a Principal, all its officers, directors and principal stockholders need not individually sign, certify nor file the certificate when they all have the same record. When their previous participation records are identical the officer authorized to sign for the corporation will list on the certificate the full names for all such principals connected with the corporation who do not elect to sign. Those principals who have a separate participation record outside that of their corporation must certify, sign and file. The objective is full disclosure.

- 2) Attorneys and architects with only an arms-length fee arrangement for services;
- 3) Sub-contractors;
- 4) Minor corporate officers who do not exercise control over an entity or who have no significant involvement in a project, as determined by HUD, need not complete a previous participation submission ;
- 5) Persons or entities with passive ownership interests greater than 25% (10% if a corporation) and officers and directors of corporations which are passive principals (e.g. pass-through/ shell company);
- 6) Parties whose sole interest is that of purchaser or owner of less than five individual unit(s) in the same condominium or cooperative development; and parties whose sole interest is that of a resident;
- 7) Passive Tax Credit investor partners are exempt in accordance with Section 2(2) of the Preservation Approval Process Improvement Act of 2007. (This document does not pertain to Historic or New Market Tax Credits, described in Chapter 14 Tax Credit). However they are required to submit the *Identification and Certification of Eligible Limited Liability Investor Entities, or Passive Investor Certification (See Chapter 14.10)*;
- 8) Tax credit syndicators, investor members of LLCs, investor partners of limited partnerships or any other passive partners, even in the case of an identity-of-interest. However they are required to submit the *Identification and Certification of Eligible Limited Liability Investor Entities or Passive Investor Certification*;  
[http://portal.hud.gov/hudportal/documents/huddoc?id=Passive\\_Invest\\_Id\\_Certifi.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=Passive_Invest_Id_Certifi.pdf).
- 9) Public Housing Agencies/Authorities, who are subject to separate treatment for projects redeveloped under the RAD program; and
- 10) Brokers whose services are limited to referring the loan to a lender and presenting information on behalf of the borrower.

#### D. Nonprofit Principals.

Nonprofit Principal is understood to mean “the borrowing entity and its Board of Directors” (BODs). The BODs are treated as individuals acting in the role of an officer and/or a member/director.

“Sponsor” is an informal term use for persons or entities who may do one or more of the following: locate and control the site; assemble the development team, provide financial assistance to the project or provide development experience and expertise to the project in ways other than as a paid consultant. The Sponsor is not the Single Asset Mortgagor Entity though they may also act as a Principal in the ownership entity.

1. Nonprofit entities and sponsoring parent organizations that are Principals must demonstrate financial strength, credit history, experience and capacity. Executive officers and any development consultants must provide resumes evidencing experience commensurate with the requirements of the project. Generally, analysis of personal financial information, including credit reports, HUD-92013-SUPP forms, and financial statements including verifications of deposit or available liquidity are not required of board members or officers of nonprofits. Officers will only provide the previous participation certification.
2. Where a nonprofit is not a Principal but proposes a role such as property manager, service provider, or an intermediary with a local community or constituency, the nonprofit must demonstrate experience, management ability and financial capacity to execute the proposed services. For its role as property manager, the non-profit entity and its officers must provide the previous participation certification.

#### E. Definition of Principal for Regulatory Agreement Provision Section 50.

1. For privately held entities: The provision generally requires two signatures for project sponsors. In most cases, HUD, upon the lender’s recommendation, shall approve an individual signatory to sign in his or her individual capacity and the project parent/sponsor entity to sign in a corporate capacity. In any specific deal, underwriting may conclude that an entity with the requisite control and involvement or interest in the Project which possesses a positive credit history and adequate financial strength relative to the size of the loan may serve in the capacity required by Section 50. In some circumstances, particularly involving large, capitalized, and experienced corporate entities with complex corporate organizational structures, the underwriting may not reveal any apparent individual to reasonably serve in the required capacity, whereas the parent/sponsor entity itself may possess such necessary characteristics to act as the sole necessary signatory.

The lender may consider whether the entity has been approved as an appropriate signatory to provisions similar to Section 50 in a recent Government Sponsored Enterprise (GSE) transaction. A GSE transaction means any Fannie Mae or Freddie Mac loan program, such as DUS or Risk Sharing, in which they have approved the signator on their comparable carve out

provisions. We will also consider the Federal Home Loan Bank as a GSE, if they also have similar approval. The GSE-approved entity may be an appropriate sole signatory for Section 50 if they have positive credit history and adequate financial strength. A copy of relevant excerpts from the recently-closed transactions would evidence such GSE approval.

2. For publicly traded corporations, REITs (Real Estate Investment Trust), or nonprofit organizations: The parent/sponsor entity itself is acceptable as the sole signatory. For such entities, any individual signing on behalf of the corporate entity does not sign in an individual capacity, but to bind the parent/sponsor. No personal liability will be claimed against the individuals signing in such a capacity.
3. For nonprofit borrowers, the parent/sponsor entity should be named. The Single Asset Mortgagor Entity should not be the signatory named in Section 50.
4. For any corporate entities required to execute Section 50: An officer or entity or other person authorized to bind the company in connection with the proposed transaction may sign.
5. The following prohibitions relate to Section 50:
  - a. Insertions of “or successors” language to the identification of signatories is not allowed. The Regulatory Agreement can and should be amended when there is a new individual who is responsible for the provisions of Section 50.
  - b. Riders to the regulatory agreement that attempt to limit a signatory’s liability are not allowed.
  - c. Section 50 may not be omitted simply because a currently insured project has been processed as a Section 223(a)(7).
6. The lender is responsible for the mortgage credit review of the parent/sponsor entity and to identify and verify the identity of the signatory of Section 50 of the Regulatory Agreement. The signatory will be identified in a special condition to the Firm Commitment (or in a letter Amendment to the Firm Commitment).

## **8.4 Investigating Credit and Character**

The MAP Lender’s underwriter is responsible for analysis and review of the mortgage credit exhibits, identifying credit issues and/or resolving discrepancies in order to determine that the Borrower and the Principals have demonstrated: (a) both the willingness and the ability to pay creditors in accordance with agreed terms, (b) the ability to deliver timely and satisfactory performance of contractual or business obligations, and (c) the mitigation of litigation risks by honoring prior loan obligations (especially during adverse market/financial conditions).

#### A. Use of Credit Reports and Credit Investigation.

1. Credit reports or credit histories are a means of validating and cross checking information received from the Borrower and Principals in financial statements and in application exhibits. Credit reports give a picture of payment history and financial interactions with creditors. The lender must reconcile any contradictions with a summary statement.
2. A commercial credit report for a business or a residential mortgage credit report (RMCR) for individuals must be current within 60 days of the application acceptance date, and HUD may require updated reports during processing. Merged credit reports from the three major credit bureaus are acceptable, but compiled infill reports are not acceptable. Infill reports have the potential of containing select or less reporting rather than the full reporting as in a single credit report.
3. For Principals who are individuals, credit reports are needed for the individual and for that individual's other business concerns (i.e. ownership of property management firm, general contracting or subcontracting firm, or land or property development entities, etc.). The lender should randomly select 10% or more of these other business ventures or property operating companies for credit review. The report should contain information on pending judgment(s), legal actions or suits or bankruptcy claims should be included in the report.
4. The general contractor's credit reports are required on the business entity/firm and its operating affiliates, if any. The Lender must provide credit reports for Principal(s) of the general contractor if the financial capacity and track record of the general contractor entity is deemed insufficient to assess a credit risk.

#### B. Lender's Review of the Credit Report. The lender is required to do all of the following:

1. Compare all information obtained from credit reports and histories to the financial statements provided by the relevant borrower or principal(s). Resolve or explain contradictory information.
2. Make reasonable inquiries to determine if the applicant or any principal is in default on any type of federal debt including direct loans, HUD insured loans, student loans, Small Business Administration loans or judgment liens against the property.
3. Investigate any adverse credit information that appears on the credit report and obtain a written explanation of any late payments, actions, judgments or derogatory information.

#### C. Delinquent Federal Debt, Judgments and Pending Litigation.

1. When delinquent federal debt is identified, the lender must include as part of the required application exhibits:

- a. A detailed written explanation from any applicant or principal with a prior federal default or claim, or whose credit report and financial statements contain conflicting or adverse information;
  - b. A letter from the affected agency, on agency letterhead and signed by an officer, stating the delinquent federal debt is current or satisfactory arrangements for repayments have been made; and
  - c. The lender's reason(s) for recommendation of the applicant, which may be included in the lender underwriter's review and recommendation.
2. The lender shall also investigate any other serious adverse information, including but not limited to bankruptcies, defaults on real estate mortgages, tax liens, foreclosures or deeds-in-lieu of foreclosures, and judgments and pending litigation.

#### D. Trade and Credit References.

1. HUD requires a completed Fannie Mae Form 1006, *Request for Verification of Deposit* or bank statements to verify Borrower's/Principal's liquid assets for each bank account listed in the credit report. Deposits and/or marketable securities of the Principal must be verified and examined in light of the Principal's liquid assets reported on financial statements. Both sources should be reasonably consistent, and any significant differences should be explained. When Principals' financial statements show real estate owned and other mortgage debt, credit references must include a sampling of mortgage payment histories and must confirm the character, business acumen, expertise and timeliness of the Principal in meeting their business obligations.
2. In instances where insufficient trade, credit or bank data is available to make a creditworthiness decision, a credit report with sufficient data may be used in place of trade references.
3. Written inquiries of trade references should include a copy of the certification authorizing the release of credit information.

#### E. Rejection Because of Unacceptable Character and Credit.

1. The lender's professional judgment is required in approving or rejecting Principals on the basis of character and credit.
2. The Principal should be a credit rejection if:
  - a. The Principal has a history of late payment or non-payment of creditors, or has defaulted on debt without making reasonable attempts to remedy or cure the default. The lender's underwriter may not recommend approval of a Principal with a history of default without contacting the

defaulted lender to determine the circumstances surrounding the default with a summary of these discussions included in the lender's narrative.

b. Delinquent federal debt has not been resolved or satisfactory arrangements made for repayment.

c. There are judgments or actions against the party, which:

(1) Could significantly impact the financial position of the individual/ firm or corporation, or

(2) Result in a determination that the individual/firm or corporation is an unacceptable credit risk.

d. The Principal is insolvent or is the subject of a pending bankruptcy or insolvency proceeding at the time of application, issuance of the Firm Commitment, or at the time of loan closing.

e. The MAP Lender is responsible for amending or withdrawing the Commitment application if there is a material adverse change in the Borrower's credit after application submission.

3. Principals with repaired credit may be considered for approval provided that a positive credit history has been established and sustained for a period of time encompassing both favorable and unfavorable economic conditions and that the principal has during that time been engaged in financial transactions and/or business enterprise comparable in scale to the proposed insured mortgage transaction. It is unlikely that this period of time would be less than 7 years.

4. Departmental Enforcement Center (DEC) Referrals. The MAP lender should discuss with the borrower and its Principals to ensure that any matters pending with the DEC relating to the borrower, the management agent and/or the Project have been resolved.

## **8.5 Evaluating Financial Capacity: Analysis of Financial Statements**

The financial statements should be reviewed to determine if the Borrower, and/or the Principals have the financial capacity to own and operate the property. For construction proposals, an analysis of financial statements is used to determine whether the owner and the general contractor have the singular ability to deliver the project. Financial analysis is performed on Active Principals as identified in the borrower entity's organizational structure. The lender's underwriter must determine which Principals have control of the single asset entity and the property, and must assess their financial stability and how it will impact the risk to FHA, and must review their financial statements along with these schedules. Also, the underwriter must analyze and disclose to HUD as part of their recommendation any financial interests that do not rise to the level of Principal, but nevertheless have a material impact on the creditworthiness of the proposed Borrower or its Principals.

These determinations are based on:

- a. Past financial condition,
- b. Present liquidity, and
- c. Projected future financial capacity.

#### A. Submission of Financial Statements- General.

The Borrower (if fully capitalized) and/or its Principals and the general contractor must submit with the loan application current financial statements to include a balance sheet, income and expense statement, supporting schedules, a REO schedule and the schedule of mortgage debt. Individuals will submit a Personal Financial and Credit Statement, Form HUD-92417 (or an acceptable form of financial statement e.g. balance sheet that contains a certification and criminal warning statement.) and if applicable an REO schedule and schedule of mortgage debt. See Appendix 8C for detailed requirements.

The financial analysis is used to determine the amounts available for investment in the project by performing an analysis of working capital. Working capital is the difference between current assets and current liabilities and is the cash or liquidity that exists to purchase assets, pay off debt and make up deficits from operations or fund new activities or projects. The financial analysis also determines which non-pledged assets can be readily used as collateral or pledged as security to obtain cash. See Appendix 8B for instructions on how to correctly analyze financial statements when determining the financial capability of the borrower, Sponsor, General Contractor and/or Manager of an LLC.

#### B. Section 223(f) Project Financial Statements.

1. The borrower must submit:
  - a. The last 3 fiscal years financial statements on the project and if more than 3 months have elapsed since the closing date of the most recent financial statements, submit a year-to-date balance sheet and operating statement,
  - b. Copies of the most recent insurance and property tax bills, and
  - c. 3 years of tax returns for the property or borrowing entity.
2. If the 3 years of financial statements are audited by an independent CPA or IPA, no further review is needed to validate the statements. If the statements are not audited, a CPA or IPA “reviewed” statement is required.
3. For refinance applications, if the financial statements are not audited, submit a CPA or IPA “reviewed” statement for the last complete fiscal year. “Audited,” and “Reviewed,” are defined professional standards for reports understood by CPAs. The intent of this requirement is to obtain an independent (non-identity of interest) professional review of the financial statements certified by the Owner.
4. Year-to-date financial statements may also require CPA or IPA review, or if the project has a history of stabilized occupancy and financial performance, and borrower-certified year-to-date statements may also be acceptable. Examples of when year-to-date financial statements might require CPA or IPA review include factors such as: 1) period covered is all but the last month of the fiscal year, 2) there is a soft market or case-specific risk factors, and 3) the project is applying

under the three-year rule waiver and has just reached sustaining occupancy. For this purpose “CPA reviewed” means a review by a Certified Public Accountant and “IPA reviewed” means a review by an Independent Public Accountant of the records and statements of the Borrower specifically including:

- a. The property’s financial statement(s) for the period;
  - b. Rent rolls for each month of the period;
  - c. Bank statements for not less than the last 6 months of the period;
  - d. The Borrower’s income tax return for the last fiscal year; and
  - e. Reconciliations of rent rolls to financial statements and financial statements to normalized operations, cash receipts and tax returns.
5. There may be circumstances beyond the Borrower’s control where the required financial statements are not available because of loss by fire, arson, theft, flood event etc.
- a. The Borrower must submit:
    - 1) Evidence satisfactory to the lender that the financial statements are not obtainable; and
    - 2) Project financial statements that are available including an owner-certified balance sheet and operating statement.
    - 3) The past 3 years of tax returns for the property and the borrower entity.
  - b. Lender’s case file must contain a statement from the Borrower that explains why all the required records are not obtainable and a memorandum from the underwriter to the Regional or Satellite Office Director stating that he/she has evaluated the borrower’s statement and agrees that the information is not available.
6. Any owner-certified financial statement or owner-certified balance sheet and operating statement must include certification and criminal warning found in Appendix 8C at C.4.b.
7. Past Due Payables and Past Due Project Liabilities. Past due accounts payable and outstanding liabilities for project operating expenses must be cleared and released, or otherwise fully resolved, before or at Initial Closing. Examples of such items include deferred management fees, over-due utility bills or real estate taxes, and trade payables. These items are not to be included in the eligible debt basis in the calculation of the cost of refinance/ acquisition.
8. If the transaction does not involve a Transfer of Physical Assets (TPA), and if approved by the Regional Center Director, surplus cash notes may be established for payables owed to a related entity. Accounts payable and outstanding liabilities that are not past due do not need to be resolved at or before closing.

### C. Review of Financial Statements and Other Documents.

1. A current financial statement must be no more than 3 months old when Form HUD-92013 is submitted to the lender for Firm Commitment review. The lender must determine financial stability and financial strength, unless the Active Principal and/or the Sponsor are a public company with an investment grade credit rating.
2. Exceptions:
  - a. The credit investigation or other circumstances may warrant more current financial statements.
    - 1) Assess the adequacy of each Active Principal's liquidity and its ability to provide immediate and ongoing support to the property, as well as to any asset that is in financial difficulty. For those properties in financial difficulty, consider that property's strength as well as liquidity sources outside the property, such as the Principals and/or the Sponsor, as applicable. The lender must look for likely future events that may drain cash resources from the Principals.
    - 2) The lender may include other sources of Principal cash flow in the analysis, if the source and stability of the cash flow has been verified by reviewing historical tax returns. Do not include interest income from notes receivable, real estate investment income, dividend income and Principal salaries.
  - b. Audited or reviewed financial statements prepared by a CPA or IPA may be up to 1 year old. The audited or reviewed statements must be supplemented with year-to-date financial statements and supporting documentation, which may be management agent-prepared if more than 6 months have elapsed since the closing date of the audited statement.
3. A Borrower that is fully funded with adequate capital in an account in the name of the Borrower must still provide financial statements on the Principals.
4. Make a working capital determination for the Borrower, its Principals and the general contractor based upon a review of the financial statements. Adjust the net working capital for the effect of contingent liabilities and the financial needs of other projects in the planning stage or under construction, adjusted by the percentage of completion.
5. Net worth in lieu of working capital (hypothecation of fixed assets) occurs when existing assets can secure loans or lines of credit to cover the project's financial requirements and such loans or lines of credit are confirmed as being available. In this case, the underwriter should recommend approval based on "true net worth" rather than on working capital; and require the Active Principal to provide a commitment letter from a lending institution that states:

- a. The rate, amount, term and conditions, if any, of the loan that the lending institution is willing to provide.
  - b. The date by which the commitment letter must be exercised. The date must extend at least to the anticipated date for initial endorsement.
  - c. The party that will be responsible for repayment of the loan or line of credit, if the commitment is exercised.
    - 1) Repayment may not be an obligation of the borrower entity.
    - 2) A certification indicating that the lending institution will not make any claim against the mortgaged property, mortgage proceeds, any reserve or deposit required by HUD, or against the rents or other income from the mortgaged property for payment of the loan or line of credit. This certification must contain the criminal certification found in Appendix 8A.
6. Funds provided by a parent company/Sponsor or affiliate of the Principals will require a certification from the Board of Directors or authorized agent that specifies the funds the parent company/Sponsor or affiliate will commit. Establish the availability of funds from the parent company/affiliate. Consider whether:
- a. Individual corporations have any excess operating capital (e.g. restricted assets);
  - b. Laws under which they are incorporated or their banks permit:
    - 1) Withdrawals, loans or advances to owners or sponsors.
    - 2) Stock investment in affiliated corporations.
    - 3) Guarantee of debts of associated corporations.

#### D. Letters and Lines of Credit.

- 1. Letters of intent and letters of credit cannot be used to establish financial capability. At initial endorsement, however, letters of credit may be substituted for cash to set up many of the escrows required at initial and final endorsement, or during construction. If a Borrower chooses to use cash at initial closing to satisfy the escrow requirement, a letter of credit cannot be substituted to establish the same escrow requirement.
- 2. Ratings and requirements for bank issued letters of credit. When a letter of credit is permitted, the ratings and requirements for banks issuing letters of credit for all multifamily project escrows must meet the following Ginnie Mae criteria:
  - a. Unconditional and irrevocable;
  - b. Issued by a bank in a Ginnie Mae rated institution which are insured depository institutions, which can include FDIC or National Credit Union Administration, with a rating that is acceptable to HUD (refer to Ginnie Mae Handbook 5500.3 Rev. 1, Chapter 16-8 dated 04/03/15, and Chapter 31-15(B) dated 09/18/15 for details);

- c. Is deposited into a non interest bearing account; the institution does not have to be fully insured by the United States of America;
- d. Valid and collectible; and
- e. Have a 12-month term that is renewable up to the period of the escrow or of the borrower's obligation and is acceptable to HUD.
- f. The format of the letter of credit must follow that in Ginnie Mae Handbook 5500.3, REV-1 Appendix VI-3;
- g. The Issuer must be named as beneficiary.

The Issuer must execute, in blank, a Transfer of Letter of Credit using the format included in Appendix VI-3, the original of which must be filed with the document custodian; and

- h. Any substitute letter of credit or extension that changes the letter of credit number or any terms or conditions of the letter of credit will require a new execution in blank and filing of a Transfer of Letter.

The requirements for depository institutions and deposit accounts are in found in the current Ginnie Mae MBS Guide for Issuers, 5500.3. It is available on Ginnie Mae's website at the following link:

[http://www.ginniemae.gov/doing\\_business\\_with\\_ginniemae/issuer\\_resources/Pages/MBSGuideLib.aspx](http://www.ginniemae.gov/doing_business_with_ginniemae/issuer_resources/Pages/MBSGuideLib.aspx).

3. The lender of record (as having a financial stake in the Borrower's position) may not be the issuer of any letter of credit without prior written consent of the Regional Center Director. Such consent will be granted only on an exception basis with sufficient investigation about a potential conflict of interest. If a demand under any letter of credit is not met immediately, the lender must provide the cash equivalent to the remaining balance of the letter of credit.

However, for tax credit transactions only if the Borrower uses a letter of credit as the form of assurance of completion and also requires an equity bridge loan, a tax credit syndicator may be the bridge loan lender and the issuer of the letter of credit. In this case the tax credit syndicator represents the Borrower's interests (as the equity investors have a strong identity with the Borrower.) Conversely the FHA lender represents HUD's interest. Subject to a determination of the Borrower's creditworthiness, HUD would permit the syndicator to provide both an equity bridge loan and a letter of credit, so long as the project is not used as collateral. Chapter 14.16 provides details with respect to the terms and timing of equity bridge loans.

4. Lines of Credit. On an exception basis and with prior written consent of the Regional Office Director, existing lines of credit may be used to establish a portion of the principal's financial capability. With the Firm Commitment application, the lender must have the principal provide a letter from a lending institution that confirms:
  - a. The existence of the line of credit, original amount and available balance, repayment terms, and expiration date.
  - b. The line of credit expiration date cannot occur prior to project completion.

E. Sponsor's Continuing Commitments.

1. Continuing Commitments. A written statement must be submitted from Active Principals that are Sponsors who are relied on for financial capacity indicating the parameters of their financial commitment to and contractual relationship(s) with the Borrower:
  - a. If the relationship is not intended to continue until the project reaches sustaining occupancy, the financial requirements have not been met.
  - b. Any Sponsor relied on for financial support but not having an ownership interest in the Borrower must also certify in writing the amount of funds it will commit.
2. The Firm Commitment will contain special conditions to ensure the contractual association of the Sponsor to the project:
  - a. The condition must indicate that the withdrawal of any individual/firm relied on for financial capacity requires prior HUD approval.
  - b. Identify the individuals/firms relied on for financial capacity. For confidentiality reasons, do not indicate their alphabetic designation or their dollar contribution as they are listed in the Remarks Section on Form HUD-92264-A.
  - c. Indicate that the withdrawal of any individual/firm relied on for financial capacity could result in HUD declaring the Firm Commitment null and void.
  - d. Require organizational documents reflecting such continuing contractual relationships, (i.e. for nonprofits).
  - e. If there is a change in sponsorship of the individuals/firms relied on for financial capacity and the remaining Principals do not demonstrate the capacity to meet the financial requirements of the project.
  - f. At any stage through Firm Commitment this is considered a significant deviation from the original proposal and a cause for rejection of an application.
  - g. After the issuance of the Firm Commitment, but before Initial Endorsement occurs, this is considered a significant deviation from the application for which the commitment was issued and may be cause for declaring the Firm Commitment null and void.
3. Individuals are prohibited from submitting financial statements as Sponsor and then abandoning the project and the Borrower after the Firm Commitment is issued. The lender should require a certified statement from such Sponsor stating their commitment to the project and specifying the amount of funds that will be reserved for contingent needs through Final Endorsement and sustaining occupancy.
4. The submission of a financial statement that is used to influence Federal Officials concerning a mortgage insurance risk determination when the Sponsor does not plan a continuing relationship with the borrower could result in appropriate sanctions being taken against the sponsor including suspension or debarment.
5. General Contractor with Adequate Capital. The general contractor's adjusted working capital position should equal 5% or more of the estimated construction contract.

- a. The instructions for hypothecation (See Section 8.5.C.4) of fixed assets may be applied if the general contractor does not have an acceptable working capital position.
  - b. The general contractor's ability to obtain a performance-payment bond does not negate or lessen this requirement.
  - c. The working capital amount should be adjusted for projects in construction.
  - d. If the general contractor does not have an acceptable working capital position or sufficient fixed assets that can be hypothecated, a joint venture may be established with a financially stronger general contractor provided these firms' combined working capital equals at least 5% of all construction contract amounts for projects in construction and development.
  - e. Waiver of the working capital requirement is reserved to Regional Center Directors, and will be considered only when there are specific strongly supported mitigating factors.
6. In the case of LIHTC, Historic Tax Credit or New Market Tax Credit transactions, the application may include a Letter of Commitment to fund the required equity from a tax credit equity syndicator or investor. This Letter of Commitment must specify the equity amount, pay-in schedule and other relevant details such as conditional equity pay in benchmarks, so that HUD and the lender can verify the availability of sufficient equity in a manner that meets HUD's requirements. The syndicator will typically assess the appropriate amounts of reserves at both the property and fund levels and perform certain asset management functions, including the replacement of non-performing general partners. The lender may also require additional documentation (e.g. financial statements, etc.) of a syndicator or investor to demonstrate their ability to make the future equity installments. See Chapter 14 for further guidance on underwriting an application with tax credits.

The lender should focus on and evaluate the tax credit syndicator's or the direct investor's financial strength, experience, reputation and asset management capabilities, if they have the majority ownership interest in the borrower entity, as addressed in Section 8.3.

7. Real Estate Owned (REO) Schedule and Mortgage Debt Schedule. The purpose of requiring the REO and Mortgage Debt Schedules is to determine an Active Principal's exposure to risk associated with real estate (e.g. multifamily, assisted living, commercial, office, undeveloped land, and new construction versus stabilized properties, etc.). Generally, the REO Schedule lends credibility to asset values reported on the principal's financial statements by requiring detailed information on each real estate asset, and serves as a cross-check to the financial statements. The mortgage debt schedule should include loans that are maturing, or have floating-rate resets, within the next 5 years. Other debt that has a material impact on the Principals' creditworthiness should be included as well (e.g. if they are in default or are likely to have problems with a loan over the next few years) to determine if any of the properties should be classified as a troubled asset. A troubled asset is one that has, or is likely to default on its mortgage obligations, or has significant financial management or operational problems. The credit evaluation shall include:
- a. An analysis of the various properties' net operating income, outstanding indebtedness, cash flow and valuation estimates must detail and support the lender's assessment of the likelihood of the Borrower's successfully refinancing projects that have maturing balloon debt, assuming current capital markets conditions and current availability of alternative long term financing sources. The analysis should give particular attention to Principals with a history or

anticipated incidence of adverse credit actions including (but not limited to) bankruptcies, foreclosures or a pattern of renegotiating debt.

- b. A financing plan should include both conventional financing and other FHA insured loans for any shortfall or anticipated lack of available credit.
- c. An analysis of large nonprofit or for-profit entities/ owners with large portfolios and audited summary financial statements is required. Generally, the lender can provide summary data, including a description of exposure to maturing debt obligations, a detailed listing and analysis of troubled projects, including those with recent or anticipated defaults or other material adverse actions.
- d. If a tax credit syndicator is identified, the lender's underwriter will also need to provide a brief overview and analyses of the entity. Typically a tax credit syndicator is an investor intermediary with only a limited ongoing obligation to LIHTC rental properties. Accordingly an REO schedule is not required for tax credit syndicators or investors. However, the syndicator's liquidity, track record, asset management and monitoring capability and ability to perform on its commitment to provide equity to the borrower after Initial Endorsement is a material issue for HUD Senior Underwriter's analysis of the tax credit investor/LP. See Chapter 14 for more details.
- e. The lender may present the REO and mortgage debt schedule in tabular format containing the information covered below and any other information sufficient to present their analysis and conclusions. Typically, the format is a spreadsheet accompanied by a summary description and analysis of each project. When the REO schedule materially differs from the financial statements, and are not minor variations arising from timing of statements or changes in principal balances, then the lender should investigate, reconcile and explain the differences. Refer to Appendix 8C for the itemized physical property list and the schedule of mortgage debt.

## **8.6 Prior Approval of Principals/Borrowers with FHA-Insured Balances Greater than \$250 Million or 25 or More Commercial Real Estate Assets**

- A. Particular attention and additional scrutiny to mitigate risks must be given in cases where Principals with greater than \$250,000,000 of outstanding FHA insured debt propose to submit loan applications for FHA mortgage insurance. Lenders must perform a thorough mortgage credit review and obtain HUD approval before submission of the application. In cases where Principals have greater than \$250,000,000 of outstanding FHA insured debt, the lender must not adjust for a Principal's fractional ownership percentage. Based upon the lender's review of the Principal's Schedule of Real Estate Owned (REO), the lender must identify Principals (including Principals or investors with less than 25% of ownership interest but as a practical matter have control or influence over the development

and/or operation of the project) with FHA insured assets that exceed the \$250,000,000 threshold.

- B. Principals of a borrowing entity with less than a 25% ownership interest but possessing a substantial financial interest by infusing equity in an FHA-insured transaction, and/or having decision making authority will undergo review. This may include the following types of principals:
1. Investors that have exceeded the \$250,000,000 threshold and wish to invest in a project as a passive investor with less than a 25% interest.
  2. An investor qualifying as a key financial partner from both a financial strength standpoint and cash requirement contribution but still maintains an ownership interest of less than 25%.
- C. The lender must first submit their presentation for prior approval to the HUD Regional Center with jurisdiction. The Regional Center will then forward this presentation to HUD Headquarters Office of Multifamily Housing Production for approval and return the approval memorandum to the Regional Center and lender. The presentation must address the following items:
1. An analysis of the Principal's financial strength, credit history and experience.
  2. An account of all insured and conventional debt on the REO schedule.
  3. An explanation of mortgage debt, e.g. type, maturity, age, interest rate.
  4. A full review and analysis of the operating performance and physical condition of the Principal's existing insured properties.
  5. An analysis and projection of the Principal's cash flow and liquidity for the estimated period of time required for proposed insured projects to achieve sustaining occupancy.
  6. Previous Participation, Form HUD-2530.
- D. Appendix 8D sets forth the instructions and program requirements for applicants to file a prior approval application to the HUD Regional Center with jurisdiction. The Appendix provides guidance on mandatory and voluntary prior approval, the scope of review, the reviewing authorities, use of the approval once granted, the duration of approval, loan committee actions, lender fees and the appeal process.
- E. Applicability. Prior approval applies to all applications for all MAP multifamily insurance programs, except for refinancing pursuant to Section 223(a)(7). However, in determining whether a Principal meets the threshold of insured loans totaling \$250,000,000 or more, lenders must include all FHA insured loans in the total, including healthcare loans (but not including Housing Finance Agency or Government Sponsored Enterprise risk-sharing loans). The prior approval will be effective and may be relied upon for 24 months or lesser period specified by HUD, from the date of the credit approval.

## 8.7 Secondary Financing

The amount, form, terms and conditions of any permitted secondary financing must comply with the guidance herein and 24 CFR Sections 200.71 and 200.85. This section details new source(s) of secondary funding. Except as specifically noted in this section, the term of any subordinate loan may not mature before the term of the HUD-insured first mortgage. Additional secondary financing guidance for Low Income Housing Tax Credit projects may be found in Chapter 14.14.

A. Public Sources. For all Sections of the Act (SOA), when secondary financing is funded by sources such as HOME funds, Affordable Housing Program, Federal Home Loan Banks (FHLB), Grants, or other quasi-public, federal, state, or local governmental sources:

1. The subordinate loan must be documented by a promissory note (Form HUD-92223M, Surplus Cash Note) and may be secured with a mortgage lien as prescribed by the governmental funding source and reviewed and approved by HUD by Form HUD-92420-M, entitled “Subordination Agreement.”
2. Secondary financing (or grants lent to the property as a secondary loan) may be used to offset up to 100% of the applicable SOA equity requirements, and may also be used to finance non-mortgageable costs, which when added to the HUD mortgage and required equity contribution, may exceed 100% of the project’s Fair Market Value (FMV) or Replacement Cost. None of these sources may be substituted for Tax Credit Equity and all remain subject to the 75% cap on payment from surplus cash.
3. Non-mortgageable costs (i.e. replacement cost items, not eligible for inclusion in the HUD insured loan) to be financed by the secondary loan, must be certified by the funding source to be reasonable and necessary to complete the project. Documentation to this effect must be included with the application submission.
4. The term of a subordinate loan should generally not expire before the term of the HUD insured first mortgage. The underwriter may consider exceptions on a case-by-case basis for public debt when other HUD programs (e.g., the HOME program) require shorter amortizations and the risk is mitigated. Examples of mitigants include items such as significant additional public funds, low loan-to-value or loan-to-cost ratios, below market rents or higher than minimum debt service coverage.
5. Where the source of the secondary financing is HOME program funds, HUD will permit the Rider/Restrictive Covenant Agreement to be modified such that the restrictive covenants are not subordinate to the FHA insured security instrument. Additionally, HUD will permit the Restrictive Covenant Agreement with a modified Rider/Amendment to Restrictive Covenants to be recorded prior to the FHA insured Security Instrument in order to ensure that the affordability restrictions will not terminate in the event of a foreclosure of the FHA-insured first loan.

B. Private Sources – Section 223(f).

1. Secondary financing from a private lending source must be evidenced by a promissory note (Form HUD-92223M, Surplus Cash Note) that may not be modified or altered in any manner without the written consent of HUD. The promissory note must be accompanied by the required secondary financing rider; a sample of the rider is found in the Multifamily Program Closing Guide as Part 5.1.

Private secondary financing is permitted to offset mortgageable and non mortgageable costs up to the difference between the loan-to-value percentage and a maximum combined debt of 92.5% of the FMV, except in instances when private secondary financing is combined with federal, state or local governmental agency secondary financing. (In these instances, the governmental loan, in aggregate with the HUD first and private second, may exceed the property's FMV.) The 92.5% limitation on combined debt does not apply to Low Income Housing Tax Credit transactions, in which primary and secondary debt together may equal but not exceed 100% of total development costs. (See Chapter 14 for details.)

2. Private secondary financing up to 92.5% total LTV (including both HUD-insured and private secondary financing) may be secured by a lien encumbering the real property.

NOTE: Except for the limited instance in Section 8.7.C below, secondary financing from private sources is not permitted under any other SOA.

3. Mezzanine Financing. Mezzanine financing is a subordinate loan usually secured by a pledge of ownership interests, rather than by a secondary lien on the real estate or an obligation of the Single Asset Mortgagor Entity. Mezzanine debt terms must be fully disclosed to and approved in writing by HUD. Any mezzanine debt that remains from a previous financing of the property is subject to the secondary financing guidance in this section. Payments on mezzanine financing may be made only from surplus cash, and the debt may not mature before the FHA insured loan. Mezzanine loan interest rates will typically be higher than that of the first mortgage, but must be reasonably consistent with market rates for mezzanine debt. Additionally the interest rate must not be so high that it jeopardizes the ownership stability of the property, or that the interest due cannot reasonably be expected to be repaid from surplus cash. Interest due or accruing on the mezzanine loan must be approved as reasonable by HUD.

In the event of nonpayment or default on the mezzanine debt, any transfer of an ownership interest in the borrower entity or in its principals to the mezzanine lender must have prior written approval by HUD, through the Transfer of Physical Assets (TPA) process. The mezzanine lender may exercise no enforcement remedies against the real estate or against the borrower entity during the term of the mezzanine loan, nor may the mezzanine lender take action that would trigger a Transfer of Physical Assets (TPA) without HUD approval.

NOTE: Project-specific exceptions or waivers to these policies for mezzanine financing must be approved in writing by HUD, and documented in a HUD-2 waiver form.

C. Private Sources -- New Construction/Substantial Rehabilitation. Private secondary financing is not permitted under Section 221(d)(4) or other new construction/substantial rehabilitation first mortgage programs. The only exception to this consideration is Seller-financed secondary debt (aka seller take back note). The Seller-financed secondary debt must meet both of the follow criteria:

1. The FHA loan to replacement cost is less than 50% (80% loan ratio for tax credit applications) of the mortgageable cost; and
2. The Seller financed secondary debt is either:
  - a. An arms-length transaction; or
  - b. It involves an identity of interest transaction, and the selling price of the land or building is not greater than the property's "as is" value."
3. Seller-financed subordinate debt must also meet all of the following:
  - a. It is an inferior cash flow debt, i.e. payments only from up to 75% of surplus cash, if available;
  - b. It is documented in a promissory note that is not recorded and not secured with a lien against the property;
  - c. It does not contain any provision of foreclosure that would threaten the first mortgage;
  - d. It is subject to automatic re-subordination in any subsequent refinancing of the first mortgage; and
  - e. The subordinate debt does not have a balloon payment or maturity prior to maturity of the FHA-insured first mortgage.

D. Section 223(a)(7) Refinance Program. For Section 223(a)(7) applications, secondary financing terms are governed by the SOA of the underlying insured mortgage, but shall not be used directly or indirectly to provide funds for an equity takeout or a Transfer of Physical Assets.

E. Commitment Condition for Repayment of Public or Private Secondary Financing. Required repayment of this and any other secondary debt, including interest, must be made solely payable from up to 75% of available surplus cash. Consider using Form HUD-92223M or including the following language in the secondary financing promissory note, or otherwise ensure the transaction provides for the following:

*"So long as the Secretary of Housing and Urban Development or his/her successors or assigns, are the insurers or holders of the first mortgage on (insert project name and FHA Project No.), payment(s) due under this Note, any secondary debt instruments shall be payable from up to 75% of available surplus cash. Non-project sources that are outside the Mortgaged Property may also be used to repay subordinate financing. The term surplus cash is defined in the Regulatory Agreement dated (insert date) between HUD and (insert name of borrower). The restriction on*

*payment(s) imposed by this paragraph shall not excuse any default caused by the failure of the maker to pay the indebtedness evidenced by this Note."*

This language does not need to be added to the Subordination Agreement (HUD-92420M) or the Secondary Financing Rider found in the Multifamily Program Closing Guide, Part 5.1.)

F. Secured Public Secondary Financing Conditions. The borrower may secure a Surplus Cash Note (HUD-92223M) with a subordinate lien from a governmental agency against the property under the following conditions:

1. The lender on the insured mortgage must consent to the placing of the subordinate lien and agree that its existence could not create a basis for default on the first mortgage.
2. There must be a simultaneous closing of the subordinate financing documents and the insured first mortgage loan documents. Both the subordinate and first mortgage closing documents must be recorded either before or after closing. Please note that recordable closing documents are frequently recorded in advance of actual closing, however funds do not flow until closing.
3. The terms of the subordinate mortgage must be:
  - a. Approved by the Field Counsel;
  - b. Consistent with the terms of the insured Surplus Cash Note, the first mortgage, the Regulatory Agreement and all HUD regulations and requirements.
  - c. The subordinate mortgage shall not contain a cross default provision or any right of foreclosure before the termination of the FHA insured mortgage.
  - d. The term of the subordinate mortgage must be extended, if:
    - 1) The Promissory Note is due, and there are no surplus cash funds or residual receipts available for repayment, and the first mortgage has not been repaid in full. (Distribution of residual receipts must be approved by HUD Asset Management and can only be approved by the terms of a written agreement between HUD and the owner.)
    - 2) HUD grants a deferment of amortization or forbearance that results in an extended maturity of the insured mortgage.
    - 3) The maturity date of the subordinate mortgage is prior to the term of the FHA-Insured mortgage.
  - e. The subordinate mortgage must be assumable when a sale or transfer of physical assets occurs and the insured mortgage remains in place.
    - 1) The holder of the subordinate mortgage cannot require that more than 75% of the net proceeds of the sale or transfer be applied to the reduction of the loan.
    - 2) For these instructions, net proceeds are the funds available to the original borrower after:
      - (a) Correcting any monetary or covenant default on the first mortgage.
      - (b) Making:
        - (i) Required contributions to any reserve funds.
        - (ii) Needed improvements to the property as evidenced by HUD's annual inspection reports.
  - f. The subordinate mortgage must automatically terminate if HUD acquires title to the project by a deed in lieu of foreclosure.

g. No more than 75% of surplus cash may be pledged to the repayment of the subordinate loan(s).

G. Unsecured Private Secondary Financing Conditions. Terms of unsecured private Promissory Notes must reflect those provisions found in: Form HUD-91710M, Residual Receipts Note [Non-profit Borrower], or Form HUD-91712, Residual Receipts Note [Limited Dividend Borrower], or Form HUD-92223M, Surplus Cash Note [Profit Motivated Mortgagors] based upon the type of borrower; or must include the terms set forth in the Secondary Financing Rider. See the Multifamily Program Closing Guide, Part 5.

1. Form HUD-91710M, Residual Receipts Note (for Non-profit Mortgagors) and Form HUD-91712M, Residual Receipts Note (for Limited Dividend Mortgagors).
  - a. Principal and interest shall be due and payable on or after the maturity date of the HUD-insured mortgage.
  - b. If the HUD-insured mortgage is prepaid in full, the holder of the residual receipts note has the right to declare the entire principal sum or any remaining balance including any accrued interest immediately due and payable.
  - c. Prepayments to principal and interest:
    - 1) may be made (a) from the residual receipts as defined in the Regulatory Agreement only after obtaining written approval from HUD or (b) from sources other than Project Income or Project Assets, e.g., syndication proceeds.
    - 2) may be made only after final endorsement of the insured mortgage and after the end of a semiannual or annual fiscal period.
    - 3) if unauthorized prepayment is accepted, the funds shall be returned to the project immediately upon discovery.
  - d. The residual receipts note is nonnegotiable and may not be sold, transferred, assigned, or pledged by the payee.
  - e. Presentation, demand and notice of demand, nonpayment and protest of the residual receipts note are waived.
  - f. Interest on the note must not compound.
2. Form HUD-92223M, Surplus Cash Note (for all other mortgagor entities; formally called the Promissory Note). The conditions and limitations are the same as Form HUD-91710M, except that:
  - a. Provisions may be made for interest payments annually or semiannually or at the end of a fiscal period. However, the Note should provide for interest to accrue and be payable in full at maturity.
  - b. Prepayment of principal or any payment of interest must be limited to sources other than Project Income or Project Assets, e.g., syndication proceeds or surplus cash as defined in the Regulatory Agreement.

- c. Payments on promissory notes will be made only as permitted by the applicable Regulatory Agreement, but prepayment of the promissory notes from sources other than the project is permitted without HUD approval.
  - d. Should any unauthorized prepayments be made, as determined by HUD, it shall be the responsibility of the borrower to return them to the project.
  - e. Interest on the Note must not be compounded.
- H. Tax Credit Equity Bridge Loans. Tax credit equity syndicators or investors (with or without an identity of interest with the MAP Lender) may make bridge loans to fund required equity contributions for LIHTC, Historic or New Market Tax Credits during the construction or substantial rehabilitation period as described in Chapter 14.16.
- I. Identify all subordinate loan funds in Section III “Source of Funds to Meet Cash Requirements” Form HUD-92264-A.

## **8.8 Required Application-Processing Exhibits and Lender and HUD Responsibilities**

The lender shall utilize HUD’s standardized application exhibit checklist to facilitate the electronic submission of the application to aid in HUD’s completeness review of deliverables and to record underwriting processing results and conclusions for both pre-application and firm applications. The standardized checklist is a concise structured template organized with separate sections directly related to each technical discipline. The template will permit the HUD-delegated underwriter and lender to locate exhibits within the application binder, which will in turn expedite the application review process while reducing HUD’s risk during the underwriting analysis of the application. These application templates are for use for all program applications submitted under the Multifamily Accelerated Processing with the exception of Section 223(a)(7) applications. The lender’s application submission templates for mortgage insurance are:

1. Underwriter’s Narrative
2. Application Checklist
3. FHA Summary Report (The Wheelbarrow)

### **A. General Responsibilities of Lender’s Underwriter.**

Underwriting multifamily projects is a process for evaluating the character, capacity and creditworthiness of the sponsor, borrower and its principals, the general contractor, and in the instance of an identity of interest, the property management company, in order to reach specific conclusions resulting in the approval (with conditions, as appropriate) or denial of a mortgage insurance application.

The Lender must assess the borrower's ability to manage all of the responsibilities of the ongoing operations of multifamily properties, including the development, construction, completion, and lease-up for new construction proposals and property maintenance, tenant relations, financial and performance reporting and effective management for existing properties.

The lender's underwriter must:

1. Identify the borrower and its principal entities or individuals and present a complete, consistent and coherent picture of the financial capacity and creditworthiness of the borrower and the various principals.
2. Analyze the creditworthiness of the sponsor(s), the borrower entity, if formed, and its principals and/ or individuals and the contractor. If a borrowing entity is not yet formed at the time the firm application is submitted, the MAP Underwriter must still perform the financial and credit analysis on the principals and/or individuals. The underwriter must demonstrate that the principals and/or individuals have the character, capability, creditworthiness and commitment to provide expert leadership, working capital and cash needed to close the proposed transaction(s), complete the development process, as applicable, and to support the operations of the property. This determination is made in light of the obligations that may already be required of the principal due to ownership of other business interests and real estate projects.
3. For existing mortgagor entities and properties, evaluate the financial performance of the mortgagor and the property based on its financial statements and other operating reports, (e.g., rent rolls) and credit history to determine eligibility, mortgage amount and conformance to program requirements.
4. Conduct a mortgage credit review to include:
  - a. The balance sheets for principals as discussed in Appendix 8B, "How to Analyze Financial Statements" and in addition to the Schedule of Real Estate Owned and other relevant schedules.

In each case the lender will conduct sufficient diligence to determine what should be an appropriate period of past financial review. Character is best demonstrated during periods of economic distress and so a review of at least one complete business cycle (means the entity's fiscal year) is necessary. Any material credit problems in the last 2 to 5 years should be carefully reviewed and may result in an application rejection. Events that occurred before that period if, for example more than 8 or 10 years have passed, would not have as material an impact on creditworthiness but may still be relevant. The lender should consider all relevant factors in the analysis and credit approval decision.

- b. Determine whether the sponsor(s) has (or will have, given proposed transactions) existing insured mortgage balances exceeding \$250,000,000. If a sponsor has obtained prior approval to exceed this amount, submit a copy of the Prior Approval Decision together with any other documents identified as required by the Prior Approval Decision. (See Appendix 8C for prior credit approval instruction.).
5. Determine if there is incomplete or inconsistent information, or discrepancies between the information included on the financial statements and in the credit reports. Any inconsistencies must be reconciled.
6. In addition to the formal documents and credit investigation described above, the lender's underwriter must conduct and describe the results of an internet search of each principal and determine if there is any information that raises concerns about credit worthiness and address any negative information.
7. Provide the Office of Foreign Assets Control (OFAC)/Terrorism checks and verifications on principals which are required by the U.S. Patriot Act. These checks must be completed and documented no later than the time of Initial Endorsement, whether or not the lender is a regulated financial institution. The OFAC verification is not part of MF Regional/Satellite Office review except to the extent that the lender has identified problems during the OFAC check. OFAC requirements are administered by the Department of the Treasury and lenders should refer to the Treasury's website <http://www.ustreas.gov/offices/enforcement/ofac>, for any questions.

#### B. Additional Exhibits Required of Project Participants.

The borrower shall provide the following exhibits for the following participants:

1. Exhibits required for participating professionals, officers of corporations:
  - a. Identity of Interest of Borrowers Using BSPRA - General contractors with an identity of interest with the borrower may be either independent businesses with an ownership interest created in the borrower entity primarily to obtain the Builders and Sponsors Profit and Risk Allowance (BSPRA) or businesses owned and operated by a Principal of the Borrower. Notwithstanding any identity of interest, the general contractor is required to provide the identical exhibits as a participant.
  - b. Management Agent - A detailed resume is required for management agents even when they have no ownership interest in the Borrower or identity of interest with a Principal. Credit reports should be required of management agents to evaluate the agent's business practices and timely payment of accounts. Analysis of financial statement is generally not required, unless the agent has an identity-of-interest with a Principal, or where financial statements are necessary to evaluate the capacity of the management entity to perform its management role.

- c. Fee Developer/Consultant - Fee developers, packagers, consultants and other professional persons or organizations are sometimes retained to assist nonprofit Sponsors that might lack needed experience. Such services might include assisting with project development, financial structuring or HUD processing. Packagers and consultants must provide resumes evidencing their qualifications, and the developer must provide credit reports and financial statements when their services are critical to project viability.
- d. Design Architect/Engineers - Design professionals must provide resumes establishing their credentials, competence and experience commensurate with levels of expertise and experience required by the project. Absent an ownership interest in the Borrower that would otherwise qualify the design professional as a Principal, no other mortgage credit exhibits are required.
- e. Executive Officers of Borrower - Officers with less than 10% of the voting stock of a for-profit corporation but who qualify as a principal of the Borrower, may be required to submit resumes and demonstrate appropriate competence and experience to provide an accurate picture of character, capacity and commitment.
- f. Executive Officers and Directors of Publicly Traded Corporations - are not required to submit mortgage credit exhibits as individuals, notwithstanding their stock ownership inasmuch as such firms are regulated by the U.S. Securities and Exchange Commission (SEC). The SEC-required annual corporate report (Form 10-K) and quarterly corporate report (10-Q) provide complete financial statements, background and history of corporate operations as well as resumes and compensation of corporate officers and disclosure of conflicts of interest of officers and directors. In addition, the credit of publicly traded corporations is rated by agencies such as Standard and Poor's, Fitch and Moody's. When a publicly traded corporation is a Principal, Forms 10-K and 10-Q and agency credit ratings may be accepted in lieu of mortgage credit exhibits.

## C. Evaluating Nonprofit Sponsors and Borrowers

### 1. General.

Nonprofit Borrower/Sponsors (whether national, regional, or local) must have the experience and financial strength appropriate for the development and ownership of the proposed property. (Appendix 8D sets forth the evaluation of the nonprofit.) The nonprofit sponsor being evaluated may not have equal strength with respect to all criteria. In transactions where the Borrower/Sponsor's ownership structure contains multiple entities performing differing functions, the lender must evaluate the nonprofit and each of the other entities on their capacity to perform its particular function, e.g. ownership, property management, acquisition, development, resident services or asset management. This includes the need for prior acceptable history of successful development, ownership and management of assets similar in size and complexity as the proposed project. Therefore, only the criteria for the areas in which the nonprofit entity has direct responsibility or authority need to be applied during the evaluation process. The eligibility of

prospective nonprofit Sponsor/Borrower must be determined before a Pre-application approval or Firm Commitment is issued.

The lender must include in the Underwriter Narrative summary a description of the party(s) paying pre-development costs, in addition to the follow written explanations:

- a. Details of any proposed rent/income restrictions on the property to be developed by the nonprofit.
- b. Developer's Agreement or any other document which shows the relationship and work responsibilities of all parties associated with the transaction.
- c. Explanation of the terms and conditions of the Housing Consultant's contract, if applicable. The fee for the Housing Consultant shall be an expense of the borrower.
- d. Memorandum of findings and recommendations:
  1. Must include a description of the relationship between the nonprofit and any profit motivated entities involved in the transaction.
  2. The determination of eligibility or ineligibility of the nonprofit sponsor/borrower must be approved by the HUD office with jurisdiction.
- e. Explain any nonperforming assets in nonprofit borrower/sponsor portfolio in conjunction with the REO review.
- f. Detailed explanation of the motivation for sponsoring the project including a history of the organization's involvement in multifamily housing.
- g. The management agent must have a minimum of 3 years of experience in managing at least 5 properties comparable to the proposed property in scale, complexity and regulatory compliance requirements. A property manager must demonstrate adequate property management experience with properties comparable to the subject property.
- h. Signed written resolution of the nonprofit's directors or trustees, acknowledging the responsibilities and obligations of sponsorship and continuing ownership, and that the subject proposal reflects the will of the board and/or the membership of the organization.
- i. Detailed statement of arrangements made or proposed for the following (listing principals involved, their relationship with the nonprofit sponsor/borrower, the terms of the arrangements and the circumstances surrounding each):
  1. Land on which the project will be built.
  2. Project construction, including selection of general contractor, subcontractors and architect.
  3. Legal and consulting services.
  4. Project financing, including any discounts.

**NOTE:** A national, State or regional organization acting as a cosponsor must submit a separate Form HUD-3433 and Supplemental documentation.

- j. The nonprofit sponsor must have diverse and stable funding sources with recurring revenue and, if required, a proven record of raising sufficient funds to meet its operating needs. The lender must identify whether the nonprofit sponsor's primary funding sources are from fees on development projects or from sources such as public funding, public contracts, grants or donations that may be subject to budget or funding constraints.

**D. Mortgage Credit of the Nonprofit Sponsor and Borrower.**

1. The underwriter narrative should summarize the review of Form HUD-3433 to determine if the nonprofit sponsor/borrower is qualified to start, complete and operate a project under the insured loan programs. The lender must determine that the nonprofit sponsor/borrower is acting on its own behalf, or if either knowingly or unwittingly acting under the influence, control or direction of any outside party seeking to derive a profit or gain from the proposed project—such as a landowner, real estate broker, contractor, architect, attorney or consultant.
2. Credit investigation analysis.
  - a. As with for-profit sponsors, the lender's underwriter must make a determination of the individuals and entities with decision-making and operational authority over the project. The underwriter will provide an in-depth written analysis on the aspects of the mortgage credit review in the underwriter's narrative.
  - b. Check that the borrower/sponsor has no unresolved issues related to payment history and check credit references.
3. Financial data analysis.
  - a. Determine the amount of cash and liquid assets available for investment in the project and overall financial condition of the sponsoring group, and in particular whether the financial statements indicate that income will be sufficient to meet the expenses incurred by the group.
  - b. Financial statements of many large nonprofit organizations show various fund accounts, such as general and building fund, etc.
    - 1) Identify any inter-fund receivables and payables that cancel each other.
    - 2) Do not consider restricted-use funds in the analysis.
    - 3) Review the Public Records section of the credit report to eliminate assets, which were used as collateral in secured borrowing.
  - c. The project size and complexity should be consistent with the abilities of the sponsoring organization.

**E. Submitting Form HUD-3434, Certificate of Relationships and Non-profit Motives, and 3435, Certification of Contractual Relationship.**

1. At the Firm Application stage and prior to initial endorsement (beginning of construction in the case of insurance upon completion), the sponsor and borrower must certify on Form HUD-3434, their relationships with parties or firms furnishing land and services.
  2. Such parties or firms must certify on Form HUD-3435 their relationship with the sponsor and borrower.
  3. If there is a change in the certified relationship, the sponsor, borrower and other parties must furnish additional certifications with respect to each change.
  4. All relationships are subject to HUD approval.
- F. Nonprofits may earn a non-profit developer fee, but not BSPRA, on a new construction or substantial rehabilitation proposal under Sections 220, 221(d)(4), 231, or 241(a).
- G. Nonprofit Borrowers may include a consultant fee as part of the replacement cost to be paid from the Organizational line item. The selection of a housing consultant is the responsibility of the Sponsor/Owner who will execute a consultant contract or agreement that engages the consultant to assist the Sponsor/Owner in the development process. The MAP Lender will review and explain the terms of the housing consultant contract in the Underwriter's Narrative, but does not approve the contract nor determine compensation limits. The resume(s) are to be submitted with the FHA loan application. HUD will permit a consultant fee under the following conditions:
1. As currently permitted, as part of the developer fee where one exists;
  2. Where a developer's fee is not permitted in the loan, including those loans that use a BSPRA, a consultant fee may be paid from the Organizational line item in Section G on Form HUD-92264;
  3. Use of a consultant fee is limited to nonprofit sponsored projects that have retained a consultant to assist in the origination, development, financial services (non-tax credit deals) and/or loan processing of the project. The agreement between the Nonprofit Borrower and consultant shall outline the services to be provided and fee amount;
  4. The fee amount shall be based upon complexity of the transaction but limited to the greater of \$40,000 or 10 percent of the estimated total for all improvements, total carrying charges and total legal, organizational and audit fees; and
  5. No more than 50% of the consultant fee shall be paid at initial endorsement, with the remainder to be paid during the construction period and final endorsement as described in the consultant contract.
- H. Nonprofit Sponsor and a Profit-Motivated Borrower Entity.
- A nonprofit sponsor may establish a profit-motivated borrower entity for the purpose of owning a tax credit project or obtaining BSPRA and distributions from surplus cash. Such a request may be approved provided:
1. The Borrower's legal counsel's opinion determines that there is no legal impediment that would prohibit approval of this relationship structure.

2. The nonprofit agrees to be regulated by the terms and conditions of the regulatory agreement (Form HUD-92466M, Regulatory Agreement Multifamily Housing Projects) applicable to a profit-motivated entity.
3. The nonprofit is subject to the mortgage limitations applicable to a profit-motivated entity.
4. A working capital deposit is required.
5. A nonprofit developer's fee is not included in the mortgage; the nonprofit can include BSPRA.
6. If the nonprofit provides evidence that it has obtained exemption from real estate taxes, the tax exemption must run with the real estate and not with the type of sponsorship.
7. The Borrower's legal counsel's opinion addresses any potential tax consequences, and determines there will be no change in the nonprofit's Section 501(c)(3) tax-exempt status with IRS.
8. Form HUD-3433 is not required in these types of applications.

#### I. Lender's Review and Recommendation

The lender's underwriter's recommendation, after review of all processing materials and third party reports, is made in a separately bound report addressed to HUD included in the underwriter's narrative.

1. The report must detail the project's financial requirements and the credit capacity of the sponsors, borrower entity, its principals and the general contractor. The lender's underwriter's narrative must detail the project's financial feasibility with an analysis of the primary risks, any mitigating factors, and the rationale for any waivers requested. The mortgage credit analysis must contain evidence of the financial feasibility and acceptability of the single asset entity, of each principal with decision making control and of investors providing funds for initial closing. Include, at a minimum, the:
  - a. Name of the borrower entity.
  - b. Composition of the borrower entity, include the tiers showing principals with control and providing the financing.
  - c. Name of the general contractor, disclosing any relationship(s) with the borrower entity.
  - d. Mortgage amount and controlling criterion.
  - e. Financial requirements for closing.
  - f. Sources of funds to meet cash requirements, including all sources and disclosing how the money will be used.
  - g. Ratio of loan proceeds to actual cost for the purpose of cost certification.
  - h. The experience level of the development team relative to the proposed project.

- i. A credit and financial review of sponsor(s)/borrower and principals and general contractor. This review must provide an overview of their financial strength, liquidity, experience, and creditworthiness and address positive and negative findings known by the lender.
  - j. Completion Assurance requirements.
  - k. Recommendation to accept or reject the proposed project.
  - l. If accepted, any conditions to be included in the commitment. (See Chapter 11)
2. Complete Form HUD-92264-A and exhibits for the type of mortgage proposed.
  3. The lender must transmit to HUD all borrower submissions and related documents.

The lender will analyze the stability of the principal's portfolio ownership and management structure, portfolio characteristics and market conditions and recommend prior approval of creditworthiness. The analysis shall include:

- i. Review of the stability of ownership and management.
- ii. Evaluation of any problems and challenges confronting the principal and the principal's plans for action in response to such challenges including:
- iii. Underperforming properties, (e.g., properties at less than 90% occupancy; properties at less than 1.1 to 1 debt service coverage; properties with significant physical or management problems).
- iv. Existing defaults and/or pending capital transactions, (e.g., anticipated refinancing or refunding, pending balloon payments, interest rate resets).
- v. Property or Asset Management deficiencies, (e.g., underfunded reserves, deferred management fees).
- vi. Suits, judgments, liens or related adverse actions.
- vii. Weak or unstable markets affecting geographically concentrated properties or other actual or prospective adverse conditions affecting a unique combination of assets and the impact of such conditions on the portfolio.
- viii. A determination whether the principal's reputation, past performance and capacity support a conclusion that insured assets will be maintained in good physical condition, with timely capital replacements and prompt, effective action to remedy problems.

#### J. Mortgage Credit Duties of HUD

1. Concentrated Risk Prior Approval - Confirm that the lender has correctly determined if prior approval is required for the sponsor to file an application. (See Appendix 8C for prior credit approval instruction).

2. Previous Participation - Perform the electronic 2530 review and approval process.
3. Underwriting Conclusions - Review lender's preliminary analysis and recommendation about the Development Team's financial capacity, experience and creditworthiness and the lender's analysis of any defaults, mortgage relief, assignments, and foreclosures relating to these projects.
4. Verify Sources of Funds - HUD will verify, through use of the Form HUD-92264-A and documents supplied by the lender, the source(s) of funds to meet cash requirements

## **8.9 Term of Mortgage and Commencement of Amortization**

### **A. Sections 220, 221(d)(4), 241(a) and 231 projects:**

1. Term: The term of the mortgage is the lesser of 75% of the estimated remaining economic life of the physical improvements or 40 years from the date of the first payment to principal. Express the mortgage term in whole or partial years, with a partial year expressed on months, for example 26 years, 3 months.
2. Amortization starts:
  - a. For Insurance of Advances projects, amortization begins no later than 4 months (the first day of the fifth month) after the date of construction completion as estimated in the Firm Commitment.
  - b. For Insurance Upon Completion project, the first day of the second month following the date of Final Endorsement.

### **3. Section 241(a) projects:**

**Term:** The Section 241(a) loan should generally be coterminous with the underlying FHA-insured first mortgage if that loan has more than 25 years remaining on its term.

**Amortization:** If fewer than 25 years remain on the term of the first mortgage, HUD will consider an amortization period up to 40 years regardless of the underlying first mortgage's amortization period, so long as the term of the insured mortgage is no greater than 75% of the project's remaining useful life.

### **B. Section 207 pursuant to 223(f) projects:**

1. The maximum term of the mortgage is 35 years or 75% of the estimated remaining economic life of the physical improvements, whichever is less, provided that the term may not be less than 10 years.
  - a. The mortgage term shall be the eligible number of whole or partial years between 10 and 35.
  - b. Express a partial year in months, for example 26 years, 3 months.
2. Amortization starts on the first day of the second month following the date of the Initial/Final Endorsement.

C. Section 223(a)(7) projects:

1. Most transactions are processed with a lower interest rate, and re-amortized either within the remaining term or with an extension of up to 12 years. Exceptions are detailed in chapter 18. Extended amortizations may reduce risk to the Department by lowering debt service requirements so long as the cost not attributable evidences the physical condition supports the extended term of the mortgage. In every case, the loan term cannot exceed 75% of the remaining useful life of the property.
2. Amortization starts on the first day of the second month following the date of the Initial/Final Endorsement of the mortgage.

## **8.10 Sections 220, 221(d), 231, 241(a) Firm Commitment Processing: Determining Mortgage Amounts, Cash Requirements and Related Items**

A. Firm Commitment Processing.

1. New Construction Loan Limits. For new construction, the insurable loan amount is the lowest of four criteria on Form HUD-92264-A, Supplement to Project Analysis: the application amount, the cost amount, the statutory limits amount, and the debt service amount, which are described below. Refer to Appendix 3A for the applicable program's required maximum loan ratios and the debt service coverage ratios needed to complete criteria for Firm applications for new construction and substantial rehabilitation:
  - a. The Application amount.
  - b. The Amount Based on Value or Replacement Cost. The result of lender's estimate of the replacement cost after completion, multiplied by the applicable program percentage.
  - c. The Amount Based on Limitations Per Family Unit - Statutory Limits.

The Statutory limits are determined by an amount attributable to per unit limitation type as adjusted by the High Cost Percentage (HCP) and dwelling use (excluding land).

Record the sum of costs not attributable to dwelling use from Section M Line 15, Form HUD-92264. Insert the same program percentage loan to cost ratio noted in A.1 above. Multiply the sum of costs not attributable with the percentage loan to cost ratio and record sum.

Strike through "*site not attributable to dwelling use*" and insert the warranted price of the land (from Section G Line 73a, Form HUD-92264) or the "as is" value of the building without the improvements if the transaction is a substantial rehabilitation loan (from Section H Remarks, Form HUD-92264). Insert the same program percentage loan-to-cost ratio noted in A.1 above. Multiply the sum of CNA with the percentage loan-to-cost ratio and record sum.

The total of all costs not attributable multiplied by the percentage loan-to-cost ratio is added to the maximum statutory limit calculated for the number of units by type. The sum is the criterion mortgage amount.

Strike a line through or leave blank the “*Total Number of Spaces,*” field, this is no longer applicable.

For the latest High Cost Percentages visit the HUD web site at:

[http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/mfh/mfinfo](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/mfinfo).

d. Amount Based on Debt Service Limit. The loan amount supported by the applicable percentage of the projects’ estimated net income. The NOI used to support this mortgage criterion may be split into two or more income streams, for example to capitalize the savings from tax abatement or to recognize other revenue sources such as from an IRP decoupling or the difference between market rents and HAP contract rents.

- 1) That portion of the maximum mortgage supported by the tax abatement or other source must be amortized over the same period as the additional NOI is available.
- 2) In order to be recognized in the mortgage proceeds, any tax abatement must run with the real estate and not with the type of sponsorship.

2. Substantial Rehabilitation Loan Limits. Amount of Loan. Rehabilitation under Section 220 and 221(d). (This includes only projects involving substantial rehabilitation.) The insurable loan amount is the lowest of four criteria on Form HUD-92264-A, Supplement to Project Analysis: the application amount, the cost amount, the statutory limits amount or the debt service amount, as described below. Refer to Chapter 3 for the applicable program required maximum loan ratios and the debt service coverage ratios needed to complete the criteria for substantial rehabilitation Firm Commitment applications.

a. The Application amount.

b. The lender’s estimate of the rehabilitation cost plus the ”as is” value of the land and existing improvements before rehabilitation, multiplied by the applicable percentages in Chapter 3.

c. Amount of Loan – Rehabilitation under Section 231. (Only for projects involving substantial rehabilitation.) The amount as permitted under the new construction program except the loan limitation is based on the estimate of value rather than the replacement cost. The insurable amount is the lowest of:

- 1) The application amount;
- 2) Property owned – 100% of the estimated cost of rehabilitation plus the lesser of:
  - (a) Principal amount of existing indebtedness against the property and closing charges,  
or

- (b) For all borrowers, apply the amounts in Chapter 3, to calculate the lender's estimated appraised value of the property before rehabilitation and closing charges less:
  - (i) Value of leased fee, if leasehold, and/or
  - (ii) Principal amount of special assessment
- 3) Property to be acquired – For all borrowers apply the amounts in Chapter 3 to calculate the lender's estimated current cost of rehabilitation/reconstruction plus the lesser of:
  - (a) Apply the amounts in Chapter 3 for all borrowers to calculate the actual purchase price of the property and closing charges, or
  - (b) For-profit borrowers, apply the amounts in Chapter 3, of the lender's estimated appraised value of the property before rehabilitation and closing charges and/or principal amount of special assessment.

B. Insurance of Advances and Related Matters. See Section 12.7 and Appendix 12 for processing instructions.

## **8.11 Sections 223(a)(7) and 223(f) Firm Commitment Processing: Determining Mortgage Amounts, Cash Requirements and Related Matters**

A. Firm Commitment Processing for Section 207 pursuant to 223(f):

### 1. Amount of loan in a purchase transaction.

In a purchase transaction involving an arm's length sale, the mortgage may not exceed the lowest of 5 criteria on Form HUD-92264-A, Supplement to Project Analysis: the application amount, the loan to value amount, the statutory limits amount, the debt service amount, and the cost amount, which are described below. Refer to Chapter 3 for the applicable maximum loan ratios and the debt service coverage ratios needed to complete criteria for a Firm application for a purchase transaction.

- a. Application amount.
- b. Loan-to-Value Ratio amount. Refer to Chapter 3 for ratios. These loan-to-values apply to both for-profit and nonprofit borrowers. (The amount based on value for Section 202 or 202/8 Direct Loan purchase transactions is 90%.).
- c. Statutory Limits Amount. This limit is based on maximum costs. The maximum per family unit limitation for refinance under Section 207 may be increased by the percentage of the HCP plus the percentage loan ratio noted in A.1.b, above. Follow the same guidance for in Section 8.10.A.1.c.

**NOTE:** Per family unit limits may be increased by the High Cost Percentages. The per-unit limits and HCP may be obtained on the HUD web site at:

[http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/mfh/hicost/hicost](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/hicost/hicost).

- d. **Debt Service Amount.** Debt service is the loan amount supported by the applicable percentage of the project's estimated net operating income (NOI). The mortgage may exceed this limit by capitalizing the savings from any tax abatement. In such cases, the net earnings estimate will not reflect that temporary tax abatement.

The NOI used to support this mortgage criterion may be split into two or more income streams to capitalize the savings from tax abatement or to recognize other revenue sources such as from an IRP decoupling or the difference between market rents and HAP contract rents.

- 1) That portion of the maximum mortgage supported by the tax abatement or other source of revenue must be amortized over the same period as the additional NOI is available.
  - 2) Any tax abatement must run with the real estate and not with the type of sponsorship if it will be recognized in the mortgage proceeds.
- e. **Acquisition Cost.** The applicable percentage from Appendix 3B must be applied to the Borrower's acquisition cost. Acquisition cost is defined as the sum of the items:
- 1) Purchase price shown in the purchase agreement and determined allowable by the lender.
  - 2) The lender's estimate of repair cost, if any, provided such costs are paid by the Borrower and are not included in the purchase price.
  - 3) The sum of reasonable financing charges, legal, organizational, and title and recording expenses paid by the Borrower.
  - 4) Eligible discounts paid by the Borrower at property acquisition.  
**NOTE:** Any fees, discounts or other amounts paid by the seller for or on behalf of the purchaser must be reflected as a reduction to the acquisition cost.
  - 5) Eligible architect's fees, mechanical engineering fees, municipal inspection fees, HUD inspection fees, if applicable, and other fees as may be determined eligible by the lender including the cost of lender third party reports.

## 2. Amount of Loan in a Refinancing Transaction.

The subject loan will be the lesser of a or b:

- a. Amounts in Section 8.11.A.1 above, except e.
- b. **Cost to Refinance.** An amount that equals the greater of the following:
  - 1) 80% of the lender's estimate of the value of the project, or
  - 2) The cost to refinance the project, which is defined as the sum of:
    - i. The amount needed to pay off the existing indebtedness as determined eligible by the lender.
    - ii. The initial deposit to the Reserve for Replacements.

- iii. The sum of reasonable financing charges, legal and organizational, and title and recording expenses paid by the Borrower.
- iv. The lender's estimate of repair cost, if any.
- v. Eligible discounts paid by the Borrower.
- vi. Eligible architect's fees, mechanical engineering fees, municipal inspection fees, HUD inspection fees, if applicable, and other fees as may be determined eligible by the lender including the cost of lender third party reports.
- vii. Less the amount of any Reserve escrow for replacement and/or major movable equipment that will be purchased as an asset of the project.

c. Release of Cash-Out / Equity from Loan Proceeds.

The maximum loan-to-value ratio for cash-out refinances is 80%. Fifty percent (50%) of any cash out proceeds after funding mortgageable transaction costs and the assurance of completion requirements must be held in an escrow by the lender until the required non-critical repairs are completed and HUD approves the release. Waivers to allow holding back a lesser percentage of cash out proceeds will only be considered when the holdback is greater than both \$1,000,000 and the assurance of completion escrow (20% of repair costs). The owner must have demonstrated the ability to complete repairs in a timely manner, and a commitment to keeping the property in good repair with no deferred maintenance.

B. Identity of Interest Purchase Transaction.

Refer to Section 13.16.

C. Determining Existing Indebtedness in a Refinancing Transaction.

Existing indebtedness in a refinancing transaction is defined as:

1. Outstanding mortgage(s) incurred in connection with the construction or acquisition of the project or with capital improvements made to the property, as confirmed by the current mortgagee. Use the pay-off letter located in Appendix 8E of this Guide.
2. Other recorded indebtedness such as mechanic's liens and tax liens, provided they did not result from personal obligations of the Borrower.
3. Unrecorded debt directly connected with the project supported by documentation from the Borrower. For such debt to be recognized, the Borrower must provide the lender with documentation that unquestionably identifies the indebtedness with the project and is not the result of unpaid operational expenses such as delinquent interest, accounts payable or deferred management fee. Examples are:
  - a. Prepayment penalties on the mortgage.
  - b. Indebtedness incurred in making significant betterments to the property.

**NOTE:** Program penalties arising from the defeasance of tax-exempt and taxable bonds and greater than 10% of the proposed FHA insured loan amount cannot be recognized. Similarly, the costs of settling prepayment penalties or yield maintenance fees associated with swaps or other derivatives (e.g., swap breakage fees) greater than 10% of the proposed FHA insured loan amount are not eligible to be included in the calculation of existing indebtedness. Prepayment penalty,

defeasance costs and/or the costs associated with prepayment of derivative instruments which are greater than 10% of the proposed FHA insured loan amount may be paid only from equity out (i.e. the loan amount is 80% LTV or less on a Section 223(f) refinancing).

4. Mezzanine Debt. Mezzanine debt may be considered in the eligible basis for refinancing only where there is no identity of interest between the principals and the Mezzanine lender or any affiliates of either party, or in cases where the funds were used to fund capital improvements.
5. Do not recognize indebtedness:
  - a. Recently placed against the project to increase the mortgage or circumvent program intent.

**NOTE:** “Recent indebtedness” for multifamily properties is defined as any debt incurred up to 1 year before the submission of an application for mortgage. Recent indebtedness can be recognized only if it was used for a non-identity of interest acquisition, for construction, for capital improvements to an existing project. Bridge loans to retire maturing debt used for such purposes are acceptable. The Borrower must provide sufficient documentation that supports recent indebtedness.

- b. Created by wrap mortgages:
  - 1) The Borrower and lender must give a detailed explanation of the purpose of the wrap and a documented accounting of the use and disbursement of the loan proceeds.
  - 2) The lender may recognize loan proceeds used for capital improvements or project operations.

#### D. Reserve for Replacements.

The cost of an initial deposit to the Reserve for Replacements is eligible for inclusion in the maximum insurable mortgage.

1. Purchase Transaction.
  - a. The purchase agreement must specify:
    - 1) Whether or not the transfer includes the Reserve for Replacements or other escrows as an asset of the project.
    - 2) Dollar amounts of escrow and/or items which the seller will pay on behalf of the Borrower, e.g., the operating deficit, discounts, initial deposit to the Reserve for Replacements.
  - b. Apply existing Reserve funds transferred as an asset of the project as a reduction of acquisition cost when computing Criterion 7 on Form HUD 92264-A.
2. Refinancing Transaction.
  - a. The Borrower must submit a list of escrows currently on deposit for the project:
  - b. The escrow account and Initial Deposit to the Reserve for Replacements must remain with the project.

- c. Apply funds currently on deposit in a Reserve for Replacements as a reduction of the cost of refinancing under criterion 10 on Form HUD 92264-A, unless the existing Reserves will fund the new loan's IDRR.
- E. Discounts and/or Costs of Issuance associated with bond financing may be eligible for inclusion in the computation of Criteria 7 and 10. See Chapter 3 for further details.

## **8.12 Firm Commitment Processing with Grants and Loans**

### **A. In General.**

These instructions apply to:

1. Grants and loans to the Borrower or its Principals from a federal, state or local government agency or instrumentality.
2. Grants and loans to the borrower or its Principals from national, regional and local community service organizations (nongovernmental source) or foundations.
3. Refer to Chapter 14 for guidance on LIHTC, Historic Tax Credit and New Markets Tax Credit equity syndication proceeds.

### **B. Application for Mortgage Insurance.**

1. At the Firm Commitment processing stage, the applicant must:
  - a. Identify the use of grant/loan funds on Form HUD-92013, Application for Project Mortgage Insurance.
  - b. Submit: A commitment letter signed by an authorized agent of the governmental agency or instrumentality or the non-government source identifying:
    - (a) Amount of grant/loan funds including all repayment terms and conditions and any regulatory restrictions that affect the operation of the property.
    - (b) Intended use of the grant/loan funds.
    - (c) Any conditions to the grant/loan and any reasons the commitment letter could be withdrawn.
    - (d) That the grant/loan is not subject to a future appropriation or funding availability that is not currently in the hands of and available for disbursement by the governmental agency or instrumentality or the non-government source.
2. Any type of grant/loan not disclosed by the Borrower may result in a rejected application or the issued Firm Commitment made null and void.

### **C. Grants/Loans from governmental agency or instrumentality.**

1. Firm Commitment. HUD will review the proposed grant/loan structure, terms and conditions and the draft grant/loan documents during Firm Commitment processing or earlier, as needed. HUD will consider waivers with reasonable terms in order to facilitate coordination between FHA requirements and those of the governmental agencies.

## 2. Initial Endorsement

- a. Before scheduling the closing, Field Counsel must review the grant/loan documents to assure their legal sufficiency.
- b. The MAP Lender must consent in writing to the placing of the subordinate mortgage and agree that its existence could **not** create a basis for default on the first mortgage.
- c. The governmental secondary financing lender must enter into the HUD prescribed form of Subordination Agreement.
- d. The Borrower may use, instead of that portion of the front money escrow provided by the grant/loan, either:

- 1) An unconditional irrevocable letter of credit issued by a banking institution with a rating acceptable to HUD and for a term acceptable to HUD; or
- 2) An agreement entered into by HUD, the governmental agency or instrumentality, the MAP Lender and the Borrower, which provides the following:

(a) HUD has:

- i. The right to approve construction advances after considering any reported noncompliance by the agency or instrumentality if the project is proceeding in compliance with approved plans and specifications.
- ii. A joint review and agreement between the MAP Lender, HUD and the governmental agency of construction progress schedules and allocation of draws.
- iii. Sole authority to resolve differences in the inspection process and the process of disbursing grant/loan proceeds.

- (b) The MAP Lender will furnish both HUD and the governmental agency with copies of the approved interim advances Form HUD-92448, Contractor's Requisition, Form HUD-92403, Application for Insurance of Advances of Mortgage Proceeds, and supporting documentation.

- (c) The governmental agency or instrumentality must process the advance from its grant or loan funding promptly and without adjustment. HUD or the MAP Lender will:
- (i) Send the governmental agency a copy of the approved requisition for its records.
  - (ii) The governmental agency must notify HUD and the lender of a need to make an adjustment the following month.

- (d) The governmental agency assumes the risk for any grant/loan funds disbursed in excess of the amount approved by HUD or the lender and agrees to replenish the excess funds within 10 working days of notification by HUD or the lender.

- (e) If a default occurs before completion of construction, the governmental agency must disburse the remaining grant/loan funds so long as the request for funds remains in the same ratio as previously authorized.

- (f) The governmental agency's attorney must render an opinion that the agreement and grant/loan commitment is legally binding on present and all future administrations.

3. Grant/loan proceeds must be advanced either:

- 1) Before the insured mortgage proceeds, or
- 2) Concurrently and on a pro rata basis with the disbursement of the insured mortgage proceeds.  
NOTE: If the grant/loan proceeds are not available at initial endorsement, HUD may either:
  - (a) Proceed to initial endorsement, but not disburse any insured mortgage proceeds until the grant/loan is in place and the funds are available for disbursement, or
  - (b) Have the Borrower/Sponsor fund an escrow equal to the grant/loan. Advances from this escrow must follow outstanding instructions for the disbursement of the grant/loan.
- 3) Release of grant/loan proceeds cannot be conditioned on the completion of specific project improvements.

4. See Appendix 12A for front money requirements and disbursement of mortgage proceeds on LIHTC projects.

D. Grants/Loans from a non-governmental source.

1. Commitment Processing.

- a. The last 3 years of audited financial statements, if available, must be submitted evidencing that the providing source has the financial capacity to meet its funding commitment.
- b. If audited financial statements are not available, unaudited statements meeting the requirements of Section 8.4.C must be provided.

2. Initial Endorsement.

- a. Before scheduling the closing, HUD must review the grant/loan documents to assure the legal sufficiency of the documents.
- b. The grant/loan funds must be disbursed before insured mortgage proceeds.
- c. Release of grant/loan proceeds cannot be conditioned on the completion of specific project improvements.

3. All work performed with the grant/loan proceeds:

- a. Must be cost certified.
- b. Must conform to Davis-Bacon requirements including submission of payrolls, certifications, etc., if payment of Davis-Bacon wage rates is required by the grant/loan program.

## 8.13 Insurance Upon Completion

Insurance Upon Completion (IUC) is an option for new construction and substantial rehabilitation projects financed under Sections 220, 221(d)(4), and 231. Mortgage insurance is provided after project completion and issuance of Certificates of Occupancy for all units. The following instructions apply to IUC projects:

- A. A financial and credit investigation is required on the Borrower, its Principals and any identity of interest general contractor.

- B. MIP is not included in Form HUD-92264 nor is it charged until the project reaches endorsement.
- C. Working Capital and Operating Deficit Escrows. Projects that apply under IUC must meet the operating deficit escrow and working capital requirements as outlined in Section 8.14 below, except for the extra 2% construction contingency portion of the working capital, which is not required.
- D. Assurance of Completion is not applicable to IUC projects. However, at endorsement, the general contractor must address latent defects by completion of the Latent Defects Escrow, Form HUD-92414M, which requires an escrow of 2½% of the total amount of the Construction Contract in the form of a surety bond, cash escrow or an irrevocable letter of credit issued by a banking institution.
- E. Breakdown of Financing Charges: In IUC projects, before issuance of the Firm Commitment.
  - 1. The mortgagee must provide:
    - a. A breakdown of financing charges and discounts by submitting Form HUD-92455M, Request for Endorsement of Credit Instrument, Certificate of Mortgagee, Borrower and General Contractor, with the Certificate of Mortgagee portion completed. The balance of the Form is to be completed before Final Endorsement in lieu of Form HUD-92023M.
    - b. Information relative to the construction and permanent interest rates and mortgage term.
  - 2. Each item is reviewed to ensure its reasonableness in relation to comparable projects and market conditions.
  - 3. HUD will inform the borrower of the fees that are recognizable for cost certification.
- F. Building Loan Agreement, Form HUD-92441M, is not applicable to IUC projects.

## **8.14 Determining the Estimated Cash Requirements for Completing the Project**

The MAP Lender has the obligation to collect and hold all funds, escrows, and deposits (initial draw, mortgage proceeds) specified for the transaction; this includes all other funds held by or at the order of the lender in connection with the loan transaction. All funds are held by the lender or a depository institution satisfactory to the lender, and must be pursuant to any applicable escrow agreement(s).

The MAP Lender must evaluate the Borrower's and its Principals' financial strength and creditworthiness, including their ability to meet the financial requirements for completing a project. The lender's underwriter is responsible for completing the Form HUD-92264-A and the electronic wheelbarrow to present their analysis of cash requirement to close the transaction.

To calculate the financial requirements, the lender must total the following:

- A. Total estimated development cost, including the amount by which the:

1. Contractor's and/or Borrower's estimate for construction exceeds lender's estimate;
  2. Owner/Architect Agreement for design and/or supervisory services exceeds lender's estimate; or
  3. Consultant's contract for services exceeds lenders estimate.
- B. Amount necessary to clear all debts on the land (or property if substantial rehabilitation). The lender must verify all indebtedness that must be paid off at endorsement. In purchase transactions, include other costs associated with the acquisition that will not be recoverable from mortgage proceeds, such as zoning expenses.
- C. Estimated cost of offsite improvements and demolition.
- D. Cost of equipping and furnishing a project with non-realty items, if applicable. Use the higher of lender's estimate or the Borrower's estimate.
- E. Working capital deposit, if required.
1. The working capital escrow requirement for new construction transactions will be 4% of the mortgage amount, half of which will be a construction contingency for cost overruns and approved change orders. Separate provisions within the working capital escrow will govern the remaining 2% construction contingency. The construction contingency portion of the escrow will be refunded to the developer at Final Endorsement if not used. Construction funded from the contingency portion of the working capital escrow may be considered as the basis for a request for an increased mortgage amount.
  2. Working capital funds are not mortgageable and the unused portion may be released to the Borrower. See Chapter 12 Section 12.15 for release of escrow.
  3. For LIHTC projects with a funded working capital reserve held by the partnership (even though controlled by the syndicator or investor and not by HUD or the lender), the funded reserve will be credited towards the increased construction reserve requirement, although the lender-controlled account must still meet the 2% working capital escrow requirement.
  4. The working capital escrow requirement for substantial rehabilitation projects is 2% of the mortgage amount.
  5. Use Form HUD-92412-M, Escrow Agreement for Working Capital. The lender will deposit said funds in an account insured or guaranteed by a federal agency. See Handbooks 4350.4, Insured Multifamily Mortgagee Servicing and Regional Office Director/PC for the depository requirements.
- F. Operating deficit escrow.
1. For all new construction and for substantial rehabilitation projects in which there will be significant resident displacement resulting in negative cash flow during the rehabilitation period, the operating deficit escrow will be the greater of:
    - a. What the appraisal and underwriting analysis determines to be appropriate; or

- b. 3% of the mortgage amount; or
  - c. 4 months debt service (Principal & Interest and Mortgage Insurance Premium) if the property is a garden apartment, or 6 months debt service (Principal & Interest and Mortgage Insurance Premium) if the property is an elevator building where a single Certificate of Occupancy will be issued before any of the units or any of the entire floors can be rented.
2. HUD will consider lender requests for operating deficit escrow draws during lease-up based on the adequacy of the remaining amount of operating deficit escrow on deposit with the project. See Section 12.15.E for further mitigation and release guidance.
  3. The amount of the operating deficit escrow for substantial rehabilitation projects with at least 90% Project-Based Rental Assistance shall be based only upon the conclusions of the appraisal and underwriting analysis and need not be the higher of 3% of the mortgage amount or 4 months of debt service. The underwriting presentation should provide a detailed estimate of the projected cash flow through the period of the rehabilitation to support the lower escrow amount.
  4. For LIHTC projects with a funded operating deficit reserve held by the partnership (even if controlled by the investor and not by HUD or the lender), the funded reserve will be credited towards the increased reserve requirements of 3% of the mortgage amount or 4 months of debt service, although the lender-controlled account must still meet what the appraisal and underwriting analysis determines to be an appropriate operating deficit amount.
  5. Use Form HUD-92489a-M, Escrow Agreement for Operating Deficit. The lender will deposit said funds in an account insured or guaranteed by a federal agency. See Handbook 4350.4, Insured Multifamily Mortgagee Servicing and Regional/Satellite Office for the depository requirements.
- G. Commitment, marketing fees, and discounts must be paid out-of-pocket by the Sponsor/Borrower and may not be paid from the operating deficit escrow.
- H. For tax-exempt or taxable bond financing, cost of issuance must be paid out-of-pocket by the sponsor/borrower and may not be paid from the operating deficit escrow.
- I. Relocation payments not included in lender's estimated replacement cost on Form HUD-92264-A may be paid from the operating deficit escrow.
- J. The lender must deduct from the estimated replacement cost the maximum insurable mortgage, any grant/loan funds or tax credit equity attributable to replacement cost items, and fees not to be paid in cash. The remainder is the estimated financial requirements needed to complete the project. These calculations should be recorded on Form HUD-92264-A
- K. Cash-Out Escrow from Land Equity.  
If land, or the "as is" property value for a substantial rehabilitation project, is contributed to meet the Borrower's equity requirement, any cash-out from the excess land or property equity above what is required at initial endorsement must be deferred until the project is complete and has demonstrated to

the satisfaction of the Regional Office that it has achieved 6 consecutive months of break-even occupancy or 12 months break-even occupancy for transactions meeting Large Loan parameters. At initial endorsement the lender will establish an escrow, and the balance thereof can be released to the Borrower after the deferral period. This does not prevent the Borrower from applying land value equity to fund the operating deficit or working capital escrows, or other cash requirements at initial endorsement. To the extent that there are excess mortgage proceeds available from the land value (or “as is value”) or other equity, and after capitalizing the required escrows etc., any remaining balance of excess mortgage proceeds may also be used for all the purposes described in Appendix 12A, paragraph D. This includes funding the working capital construction contingency escrow. See Sections 12.8 and 12.15 for specific guidance. After all escrows and cash requirements are established at initial endorsement, any balance remaining in the land escrow is deferred until operations of the project have achieved 6 consecutive months of break-even occupancy. After this period the balance of the escrow may be released to the borrower. (See Section 12.15.F for details.).

L. Cash-Out / Equity from Loan Proceeds Holdback – Section 223(f).

In cases where the Lender has determined a project with non-critical repairs is eligible for cash-out, fifty percent (50%) of the cash-out proceeds must be held by the Lender until all repairs are complete and HUD approves the release. The amount of proceeds held is any amount after the funding of any transaction costs including the assurance of completion escrow (20% repair costs) requirement. Lenders may request a waiver to allow holding back a lesser percentage of cash-out proceeds. Waivers will only be considered when the holdback is greater than both \$1,000,000 and the assurance of completion escrow (20% of repair costs). The Lender will set up the escrow at Initial/Final endorsement on Form HUD-92476.1M, Escrow Agreement for Non-Critical, Deferred Repairs. Critical repairs are not subject to this cash-out or withholding of proceeds. Critical repairs are completed before Initial/Final Endorsement and not deferred.

M. Tax Credit Equity Contribution.

1. HUD requires that an appropriate amount of the equity be invested in the project and applied to HUD-approved costs at the time of Initial Endorsement. The amount deemed by HUD to be sufficient for such purposes will depend on the circumstances of each transaction, but should be an amount that assures an ongoing relationship between the Borrower and the tax credit syndicator or investor.

The initial installment of equity must be an amount that is equal to or exceeds 20% of the total equity that will be available for the project. HUD has adopted a fixed pay-in schedule for all LIHTC transactions, and therefore waivers of the first 20% equity pay-in will not be considered (please refer to Chapter 14.15 of the MAP Guide). An example of Form HUD-92264-A to assist with the calculation of the amount of the initial and subsequent infusions of tax credit equity follows.

2. The initial installment of equity must be expended on the initial requisition at Initial Endorsement.
3. Example for Form HUD-92264-A.

There is no change in the computation to determine the cash requirements and/or front money escrow on Form HUD-92264-A. The initial installment of LIHTC equity is calculated as follows:

**Form HUD-92264-A Section II. Total Requirements for Settlement – Part B**

1. a. Development Cost .....	<u>\$14,381,216</u>
1. c Total of lines a & b .....	<u>\$14,381,216</u>
2. Land Indebtedness (or cash required for acquisition) .....	<u>\$625,000</u>
3. Subtotal (lines 1c + 2) .....	<u>\$15,006,216</u>
4. a. Mortgage Amount .....	<u>\$10,935,000</u>
4. b. Home funds .....	<u>\$650,000</u>
5. Fees not to be paid in cash .....	<u>\$0</u>
6. Subtotal (lines 4a+4b+5) .....	<u>\$11,585,000</u>
7. Cash investment required (line 3 minus line 6) .....	<u>\$3,421,216</u>
8. Initial Operating Deficit .....	<u>\$488,772</u>
9. Other Cost (Bond cost \$312,617) and \$15,000 .....	<u>\$327,617</u>
10. Working Capital .....	<u>\$218,700</u>
11. Other: Social Services Escrow \$55,000 + Fee \$2,066,897) .....	<u>\$2,121,897</u>
12. Total estimated cash requirement (sum of lines 7+8+9+10+11) ...	<u>\$6,578,202</u>
<b>Front money escrow, if any</b> (subtract line 6 from line 1) .....	<u>\$2,796,216</u>

**Section III. Source of Funds to Meet Cash Requirements**

Source A	Tax Credit Equity .....	<u>\$5,027,301</u>
Source B	Developer Funds .....	<u>\$1,550,901</u>
	Total available cash for project.....	<u>\$6,578,202</u>

The initial 20% calculation of the tax credit equity for mortgageable items is \$1,005,460. This is based upon the mortgageable tax credit allocation of \$5,027,301 x 20% = \$1,005,460; it is not based on the total cash requirements for the project. The remaining cash requirements **not** being satisfied with LIHTC equity will be satisfied in accordance with outstanding instructions. The Borrower must pay out-of-pocket when there is no available cash from mortgage proceeds.

4. Subsequent Investment of Tax Credit Equity Proceeds.
  - a. The *Commitment for Insurance of Advances*, Form HUD-92432, should contain, among other special conditions, a requirement for evidence satisfactory to HUD of an agreement that binds the investor to timely and periodically pay to the Borrower tax credit equity to contribute to the completion costs, in the aggregate amounts shown on Forms HUD-2880 and HUD-92013. To that end, HUD requires that no less than an additional 30% of total tax credit equity be contributed at no later than 65% of project completion, with an additional contribution of 45% of equity paid in at project stabilization, regardless of whether the project is a new construction or refinance. See the special conditions in Appendix 4D.
  - b. The actual amount of the initial equity investment should be reflected in the Firm Commitment

as a special condition and listed as a line item on the initial requisition, HUD Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, for immediate disbursement.

## **8.15 Bond Financed Projects**

A. Review of Financing Documents. A tax-exempt bond is a security issued by a governmental agency in which the interest income produced is free from federal income tax and sometimes free from state and/or local income tax. Financing documents associated with mortgage bonds or tax-exempt bonds are prepared and reviewed by the bond underwriter and the bonds are secured by a mortgage on one or more assets. In FHA insured transactions, these bonds are backed indirectly by an interest in the insured loan which is further enhanced by a Ginnie Mae Security.

1. The Sponsor must submit, with the application for Commitment processing, a separate statement itemizing the estimated costs of bond issuance, issuer fees and discounts and financing fees to be paid out of pocket by the Sponsor/Borrower with an explanation of the necessity and reasonableness of each cost. The lender's underwriter must check the statement for reasonableness, using the data from previously processed bond-financed projects and make adjustments where appropriate. This information is used to develop the Total Estimated Cash Requirement Form HUD-92264-A, Supplement to Project Analysis.

B. Loan Rates.

1. The construction loan and the permanent loan rates may exceed the interest rate on the bond obligations. When this occurs, the spread will create a surplus of funds which must be held by the bond trustee. At initial closing, the bond counsel must supply HUD with a legal opinion stating that any investment income received by the mortgagee but not held for its own account must be under the control of the bond trustee and will not flow through the books and records of the project. The bond documents will instruct the trustee to invest the funds in a federally-insured interest bearing account, submit the project's financial statement, or permit the Borrower to use the surplus of funds to cover costs associated with the bond financing transaction.
2. In many cases, the interest rate on the bonds will not be known during the Commitment processing, and it is not uncommon for the rate to change once the bonds have been sold and the bond interest rate has been established. If the mortgage rate changes, an amendment letter to the Firm Commitment should be issued reflecting the actual interest rate. If, due to time constraints, HUD does not have sufficient time to reprocess a higher mortgage for the project, the Firm Commitment must contain the following condition:

“Any interest savings resulting purely from a differential between the HUD-processed interest rate and the actual, final interest rate may not be construed as excess funds that may be used to offset costs in other categories at the time of cost certification. Any such savings must be applied as a mortgage reduction.”

**NOTE:** An exception to the above is that savings resulting from the early completion of construction may be used to offset cost certifiable overruns in other cost categories. Compute interest savings by:

- a. Recalculating the interest line item on Form HUD-92264, using the actual interest rate for the scheduled construction period.
  - b. Subtracting the actual interest cost recognized at cost certification from the revised interest figure developed in (1) above.
  - c. HUD will allow a total financing and placement fee of 5.5% on bond financed applications. This limit applies to all multifamily Sections of the Act except Section 223(a)(7) and is reflected in the replacement cost mortgage amount confirmed at cost certification.
- C. Bonds may be sold at a premium to investors, whereby the investor pays an amount in excess of the face value of the bonds. The premium results from the bonds carrying a higher coupon rate than is generally available in the marketplace.
1. Any premium raised by a transaction is considered part of the mortgagee, bond underwriter, or issuer's profit. However, if a mortgagee gives something of value without the expectation of being repaid, HUD considers this to be a kickback. The one exception involves tax-exempt bond transactions where the issuer of the bonds permits the Borrower to receive some portion of the premium to offset the cost of issuance so that the mortgagee, bond underwriter and issuer are simply conduits for the transfer of funds.
  2. If any of the premiums is remitted to the Borrower, it will be considered excess investment income, treated as project income, and used to reduce the total allowable cost of the project.
  3. On bond financed projects, the premiums may be treated as project income under the following conditions:
    - a. The Sponsor/Borrower cannot benefit monetarily from the excess investment income.
    - b. The premium, if accessible to or given to the Sponsor/Borrower, is considered as excess investment income.
    - c. Closing documents must detail the amount of the premium being given to the Sponsor/Borrower.
    - d. The premium may be used to pay for additional cost associated with the cost of issuance and may be applied to other recognizable cost overruns.
    - e. The Borrower's accountant or the Borrower must detail in the notes to the financial statement the amount of excess income received.
  4. For nonprofit applications, excess income generated from premiums may be applied to recognizable cost overruns. Any excess income over and above that used towards recognizable cost overruns must be transferred to the reserve for replacement account.
  5. On Section 223(f) applications, excess income generated from premiums must be transferred to the

Reserve for Replacement account.

D. Itemized Statement of Costs. An itemized statement of the costs of issuance of the obligations, discounts and financing fees paid through the mortgagee must be attached to and reflected in the Lender's Certificate, Form HUD-92434M.

1. The statement must explain why each individual item is necessary for the issuance of the obligations.
2. The lender must review the amount of each item to ensure its reasonableness in relation to comparable projects.
3. A letter from the Regional Office Director will inform the mortgagee that HUD will recognize for cost certification purposes the costs of issuance, discounts and financing fees in an aggregate amount not to exceed 5.5% of the insured loan amount, which may be included in the mortgage for all programs (except Section 223(a)(7)).
4. The mortgagee, bond underwriter, and issuer have the option of deferring collection of additional discounts, financing fees, slow draw fees, etc., through the provision of Paragraph 20(G) of the Lender's Certificate (Form HUD-92434M).
  - a. The deferred collection of these items must be an obligation of a third party. Both the third party and the mortgagee bond underwriter or issuer must attest in writing that they will not look for payment from the:
    - 1) Borrower;
    - 2) Mortgaged property;
    - 3) Mortgage proceeds;
    - 4) Any reserve or deposit required by HUD and/or the mortgagee in connection with the insured mortgage transaction; or
    - 5) Rents or other income from the mortgaged property.
  - b. The Borrower may issue, as evidence of the debt, surplus cash or a residual receipts note to the third party for costs identified in this paragraph which HUD determines to be reasonable.

E. State and Local Bond Financed Projects.

1. Prepayment of Note. State and local bond financed projects are subject to prepayment restrictions and penalty charges as provided in Chapter 11 Section 11.8.B.3.
2. State/Local Occupancy, Use and/or Rent Restrictions. Use or rent restrictions sought by the State or local jurisdiction for projects financed by proceeds from State/local tax-exempt obligations are often more restrictive than the minimum requirements of the Internal Revenue Code. The Regional/Satellite Office Director may approve a State or local restriction exceeding the minimum requirements of the Internal Revenue Code, but only if the following conditions are met:

- a. The Regional/Satellite Office Director must determine that the restriction is not likely to have an adverse impact on project occupancy, marketability or long-term feasibility. This determination must be made on a project-by-project basis.
- b. The restriction must not conflict with any applicable HUD mortgage insurance regulations or related administrative requirements.
- c. The restriction must not appear in the Note, Mortgage, Regulatory Agreement or any other HUD/FHA loan document.
- d. The restriction must be qualified to provide that it will automatically terminate in the event of either foreclosure or transfer of title by deed in lieu of foreclosure. Such a termination provision must be included in every legal instrument (e.g., deed, land use restriction agreement, Security Agreement, or financing agreement) in which the restriction appears.

F. Pre-Cost Certification Conference Information. The lender must demonstrate at the pre-cost certification conference that:

1. The net cost of negative arbitrage (i.e.: the bond escrow account yield vs. capitalized interest expense) may be recognized if there are offsetting savings in the mortgage.
2. Any rebate to the Sponsor/Borrower from the mortgagee, issuer or bond underwriter will reduce the mortgageable cost certification. The following are two samples of the most common types of rebates.
  - a. If mortgagee/bond underwriter contributes a portion of the initial service charge that was collected to pay discounts or other fees.
  - b. If mortgagee/bond underwriter refunds a portion of the construction loan interest to the Borrower or Sponsor.

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# Chapter 9

## Environmental Review and Requirements

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### 9.1 Introduction

This chapter outlines for the lender and HUD staff the policies and procedures that must be followed to meet environmental responsibilities. The lender is required to make certain application submissions. If additional or updated environmental information is required, it must be submitted in order for the application to be considered complete. The lender may submit the reports required by this Chapter and HUD staff may complete the HUD environmental review prior to submission of the application for Firm Commitment in order to expedite the review, but should do so only when it is clear that the lender will meet application for Firm Commitment deadlines and requirements.

This chapter cites many standards and guidance documents, such as ASTM standards. These are frequently updated, and as such this chapter may make references that are outdated. Wherever standards or guidance are cited in this chapter, **HUD requires reliance on the most recent edition in force**. This also applies wherever sections, chapters, or addenda of the standards or guidance are cited. The comparable sections, chapters, or addenda of the most current version in force should be referenced and relied upon. If a referenced standard or guidance has been retired and not succeeded by a more current edition, HUD requires reliance on the retired version until other guidance is issued.

#### A. Legal Authorities, Handbooks, and Forms.

1. All Federal agencies are required to comply with the National Environmental Policy Act of 1969 (42 U.S.C. 4321 et seq.) (NEPA), and the implementing procedures issued by the Council on Environmental Quality at 40 CFR Parts 1500-1508. HUD regulations implementing NEPA are contained in 24 CFR, Part 50, “Protection and Enhancement of Environmental Quality”. Related Federal laws and authorities are listed in 24 CFR 50.4 and 50.3(i). HUD may not delegate its environmental responsibilities to others; it is required to prepare the environmental review and make the appropriate environmental finding, obtain all required review, comment and approvals prior to issuing a Firm Commitment. (See 24 CFR 50.11.)
2. HUD has issued two handbooks covering environmental issues: Handbook 1390.2, “Environmental Assessment Guide for Housing Projects”, and Handbook 1390.4 “Guide to HUD Environmental Criteria and Standards contained in 24 CFR 51”. Informal guidebooks issued by HUD on environmental issues are cited in this chapter. In addition, HUD offices may make the Guide, “Choosing an Environmentally Safe Site”, which is used in the Section 202 and 811 programs, available to all projects.<sup>21</sup>

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<sup>21</sup> The Guide *Choosing an Environmentally Safe Site* is available at: <https://www.hudexchange.info/resource/83/choosing-an-environmentally-safe-site/>.

3. HUD has established environmental Form HUD-4128, “Environmental Assessment and Compliance Finding for Related Laws”, to document compliance with NEPA and other environmental Federal laws, authorities, Executive Orders, and HUD standards. HUD has established the HUD Environmental Review Online System (HEROS) – Form HUD 4128 for HUD staff to document compliance with NEPA. The use of HEROS and the Form HUD-4128 to document environmental assessments and reviews by HUD staff is required under 24 CFR 50.31. The Phase I Environmental Site Assessment (ESA) must be cited as source documentation on the relevant HEROS screens.
4. Existing apartment projects to be refinanced or purchased under Section 223(f) are categorically excluded (CE) from NEPA compliance (see 24 CFR 50.20(a)), except in extraordinary circumstances (see 24 CFR 50.20(a) and (b)), but they must comply with the laws and authorities listed at 24 CFR 50.4. CE projects must also comply with the Contamination Analysis requirements discussed at 9.3 (as required by 24 CFR 50.3(i)), and with the Lead, Asbestos and radon report requirements discussed at 9.5.A, B, and C. If a project is CE, compliance with the parameters related to Nuisances and Hazards at 9.5.P, such as pipelines, fall hazards, and oil gas wells must be documented in HEROS – HUD Form 4128. Rehabilitation projects may also qualify for a CE from NEPA compliance if they are not considered substantial rehabilitation (see 24 CFR 50.20(a)(2)(ii)). Note that for environmental review purposes, the term “substantial rehabilitation” refers to rehabilitation that does not qualify for the CE in 24 CFR 50.20(a)(2)(ii). Please see Chapter 5 for a definition of substantial rehabilitation that applies to other program purposes.
5. Pursuant to 24 CFR 50.19(b)(21), “refinancing of HUD-insured mortgages *that will not allow new construction or rehabilitation, nor result in any physical impacts or changes except for routine maintenance*” (emphasis added) is categorically excluded from the environmental assessment (EA) requirements of the National Environmental Policy Act (NEPA), except in extraordinary circumstances, and does not require compliance with the Federal laws and authorities specified at 24 CFR Part 50.4, other than for the flood insurance requirements specified at 24 CFR 50.4(b)(1). Thus, Section 223(a)(7) projects are categorically excluded. Similarly, currently HUD-insured Section 223(f) refinancing transactions that meet these criteria do not require an environmental review. However, the flood insurance requirements specified at 24 CFR 50.4(b)(1) are still applicable. For environmental review purposes, the term “maintenance” is explained in “Guidance for Categorizing an Activity as Maintenance for Compliance with HUD Environmental Regulations, 24 CFR Parts 50 and 58.” Note that this definition of maintenance is specifically for environmental review purposes. Please see Chapter 5 for definitions of alterations and repairs that apply for other program purposes.<sup>2</sup>
6. Requirements in this chapter may exceed those of many State agencies. One reason for this is if a mortgagor defaults on an FHA-insured project, HUD may become the project owner. Under Section 120(h) of the Comprehensive Environmental Response and Liability Act (CERCLA), Federal agencies that own properties are required to take “all remedial action necessary to protect

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<sup>2</sup> Guidance for Categorizing an Activity as Maintenance for Compliance with HUD Environmental Regulations, 24 CFR Parts 50 and 58, can be found at:

<https://www.hudexchange.info/resource/3197/guidance-categorizing-activity-as-maintenance-environmental-regulations-24-cfr-parts-50-and-58/>

human health and the environment” with respect to known hazardous substances upon disposition of the property. This requirement is beyond any liability releases under State or Federal law and any due diligence requirements under CERCLA.

**B. Local, State, Tribal or Federal Laws.**

1. The acronym LSTF as used in this chapter refers to “local, state, tribal or Federal”.
2. In cases where state or local laws, tribal laws, ordinances, codes or regulations are more restrictive than Federal requirements, the borrower must comply with the stricter local or state standard unless Federal law states otherwise. An Application for Firm Commitment does not relieve an owner of responsibility for compliance with state or local requirements.
3. HUD will not assume any responsibility with respect to inspection, enforcement, interpretation or determination of compliance with such state or local requirements.
4. Where the project is located on a Native American reservation, the tribal authority may assume the responsibilities of the state or local environmental protection agencies.
5. This chapter is not a substitute for requirements in the laws, regulations, and Executive Orders regarding environmental analysis and mitigation.

## **9.2 Procedures**

**A. Lender’s Responsibilities.**

1. All projects (new construction, substantial rehabilitation, refinancing or purchase) submitted under MAP require the lender to make various submissions related to Contamination as stated in detail in Section 9.3, unless the exemption for HUD-insured projects described at Section 9.1.A.5 applies.
2. The lender must provide an Environmental Report to HUD. The Environmental Report must address NEPA environmental factors, unless the categorical exclusions discussed at Section 9.1.A.4 or 9.1.A.5 apply. The Environmental Report must also address the environmental laws and authorities listed at 24 CFR 50.4, unless the categorical exclusion discussed at 9.1.A.5 applies. The Environmental Report must identify any significant environmental issues to be resolved, and is discussed in Section 9.5.
3. The lender must provide a Lead Report to HUD, as discussed in Section 9.5.A.
4. The lender must provide an Asbestos Report to HUD, as discussed in Section 9.5.B.
5. The lender must provide a radon report to HUD, as discussed in Section 9.5.C.
6. HUD environmental policy requires that there be a limitation of certain activities or actions by any direct or indirect parties to the transaction from the time of initial contact with HUD until HUD has completed the environmental review process. Initial contact includes Concept Meetings, pre-application or application submission, or other meetings or correspondence with HUD or with a lender for the purpose of preparing an application for FHA multifamily mortgage insurance.

Specifically, no action concerning the proposal shall be taken prior to completion of the environmental review which would: (1) have an adverse environmental impact, (2) limit the choice of reasonable alternatives, or (3) prejudice the ultimate decision on the proposal. Activities that limit the choice of reasonable alternatives include an action or commitment to undertake real property acquisition, repair, rehabilitation, construction, demolition or site clearance.

- a. Certain actions do not fall within such limitations, such as development of plans or designs, or performance of other work necessary to support an application for Federal, State or local permits.
  - b. Other actions do fall within such limitations, such as acquisition, demolition, modification of a wetland, or actions that adversely affect a historic property. Pursuant to the “anticipatory demolition” requirements of Section 110(k) of the National Historic Preservation Act (54 U.S.C. 306113), even before application submission takes place, any action by a potential lender or borrower, or any action by another party that the lender or borrower has the legal power to prevent, that is taken with the intent to avoid Section 106 review and that significantly adversely affects a historic property, could result in rejection of an application.
  - c. If any party is unsure as to whether an action would fall within such limitations it should seek advice and possibly approval by HUD. These requirements are distinct and separate from any early start of contractually related construction activities as discussed in Chapter 12.
7. Lenders are required to submit all the exhibits necessary to resolve any environmental issues with the Firm application submission. For lenders that use the pre-application process for new construction or substantial rehabilitation proposals, HUD requires the various reports listed in Section 9.2.A. 2-5 and the Phase 1 to be submitted at pre-application, unless otherwise indicated. The purpose of asking for certain documents at pre-application is to help make an early evaluation of any environmental issues to be resolved so t HUD can determine if all environmental issues can be resolved prior to issuance of the Firm Commitment. The letter of invitation will condition the issuance of a Firm Commitment upon the environmental review finding that there are no unresolved environmental concerns.
  8. Any identified environmental issues will require a discussion of impacts to human health and appropriate mitigation measures. The lender must provide mitigation plans for those environmental problems when the application is submitted. Remediation of site contamination is discussed in Section 9.3 of this chapter, and requires that LSTF approval of those plans be submitted with the application for Firm Commitment. The implementation of mitigation and remediation plans may, with HUD approval, continue throughout the construction period. HUD will review the lender’s plan and make it a condition of the Firm Commitment if HUD considers the plan acceptable. This would include any plans for remediation of site contamination, wetlands impacts, noise impacts, radon, historic preservation, endangered species, acceptable separation distance (ASD), and/or floodplain management issues.
  9. Removal or containment of lead-based paint or asbestos may continue beyond Initial and Final Endorsement if HUD approves.

B. HUD Staff Responsibility.

1. In accordance with 24 CFR 50.32, HUD, not the lender, is responsible for independently evaluating the information supplied by the lender in the Environmental Report, supplementing that information as needed, making the required findings and preparing the environmental review in HEROS – Form HUD-4128 and supporting documentation as the environmental record for the project. HUD will determine whether the project raises environmental conditions that are prohibited by law, Executive Order, or regulation, or which would endanger health or safety, or would put FHA mortgage insurance or the U.S. Government at financial risk or liability.
2. HUD staff shall promptly notify the lender that it will take appropriate action to ensure that the objectives and procedures of HUD environmental policy are achieved if it becomes aware that an action subject to limitation as discussed in Section 9.2.A.6 has taken place or may be about to take place.
3. Trained HUD staff must review the documentation submitted by the lender and must make a site visit. The site visit will help validate the information provided on the Phase I ESA and Environmental Report and is useful for evaluating other environmental factors. HUD staff will supplement the lender's documentation as needed, make the required findings and prepare Form HUD-4128 and supporting documentation. HUD staff must certify the completed environmental review in HEROS Form HUD-4128 as the preparer. The environmental review in HEROS-Form HUD-4128 must also be certified by an Approving Official, who has authority to issue a Firm Commitment.
4. Regulation 24 CFR 50.32 requires that a NEPA Environmental Assessment for a project with more than 200 units be sent for review and comment to the Regional or Field Environmental Officer (REO/FEO) in whose jurisdiction the project is located. The REO/FEO must also be given the opportunity to review and comment on any environmental review in HEROS - Form HUD-4128 in which the project is in the normally unacceptable or unacceptable noise zone, where the REO/FEO has prepared a special study for the environmental review, or as required by agency agreement or Memorandum of Understanding. Projects that require an Environmental Management and Monitoring Program as discussed at 24 CFR 50.22 require concurrence of the REO/FEO. Categorically excluded projects, as discussed at Section 9.1.A.4, do not require review and comment from the REO/FEO. However, it is recommended that REO/FEOs be given the option to review and comment when special analysis is required under the laws and authorities listed at 24 CFR 50.4 or the project involves potentially significant environmental concerns. REO/FEOs should be contacted for input early on during consideration of an application, including at Concept Meeting.
5. Completed environmental records must be available for the REO/FEO to review. Up to ten percent (10%) of files may be reviewed in any given year.

6. As part of its environmental review responsibilities, HUD may require additional environmental material from a lender, such as a Phase II ESA or a Biological Evaluation, even when the lender might not believe that such additional environmental material is necessary. HUD will discuss any environmental conditions in the letter of invitation for Sections 221(d)(4), 220, 241(a) and 231. Any requirements that affect project design will be fully detailed. The lender must assure that any requirements affecting project design are conveyed to the design architect for incorporation into the contract drawings and specifications.
7. The Regional Office shall ensure that all environmental conditions are resolved and the environmental review in HEROS – Form HUD4128 is completed and approved prior to issuance of a Firm Commitment.
8. When environmental reviews reveal environmental conditions that require mitigation, HUD will require completion of mitigation prior to Firm Commitment or will condition Firm Commitment on completion. HUD will discuss the requirements for completion of mitigation in the environmental review (Form-4128). Mitigation plans will be detailed in agreements and/or other relevant documents. HUD may also require an Environmental Management and Monitoring Program, as discussed at 24 CFR 50.22.
9. HUD shall mail completed environmental reviews to those who have requested them, in accordance with 24 CFR 50.23. Additional efforts for involving agencies, tribes or the public shall be made when required by the implementing procedures of the laws and authorities cited in 24 CFR 50.4.

HUD staff should refer to the specific directions and guidance contained in Section 9.4 for projects that involve remediation and or monitoring.

#### C. Qualifications of Professionals.

1. The sponsor/developer will generally select the professionals who prepare the Environmental Report, the Phase I ESA, or any other environmental information required by HUD, but the lender must verify that the professionals used are qualified for their assigned responsibilities. It is recommended that the professionals have prior HUD experience.
2. The Environmental Professional preparing the Phase I ESA must meet all of the qualification and license/certification, education, and experience requirements of Appendix X2 of ASTM E 1527-13.
3. When a Phase II study is conducted, the “Phase II Assessor” must meet all of the qualification requirements of Section 3.1.33 of ASTM E 1903-11.
4. Professionals may be required to evaluate technical areas, such as lead-based paint, asbestos, radon, noise, wetlands, flooding, historic preservation or soil stability conditions.

D. Consulting with the Hub or Program Center.

Lenders should consult early with Regional staff<sup>3</sup> on HUD environmental requirements. Local conditions and interagency relations affecting environmental review requirements differ from State to State and from field office to field office. For instance, coastal zone management requirements are not applicable in most states, but in states where they are applicable, compliance procedures differ. In some states, a letter from the state coastal zone management agency for projects in the coastal zone is required but in others, alternative review procedures make this unnecessary. Some states require special licensure of professionals evaluating asbestos, lead-based paint, radon and soil stability conditions.

### 9.3 Contamination Analysis

The purpose of the requirements of this section is to identify manmade contamination on a site, other than contamination from in-place building components such as asbestos containing materials (but see Section 9.5.B) or lead-based paint (but see Section 9.5.A), and to ensure that any contamination so identified is mitigated to the point where it would be unlikely to “affect the health and safety of occupants or conflict with the intended utilization of the property” as stated in HUD-wide policy at 24 CFR 50.3(i)(1). Laboratory analysis may reveal naturally occurring contaminants in the pathway vectors (air, water, groundwater, soil or sediment) surrounding the proposed HUD-assisted project at levels that pose a health or safety risk to sensitive receptors. Mitigation might be required depending on the intended use of the proposed project, the direction, the transmissivity, the proximity and the use of the pathway vectors with respect to the location of the proposed project.

Any potential contamination issues should be discussed with HUD at the concept meeting. It is recommended that lenders consult with HUD before a Phase II ESA is prepared.

A. Phase I Environmental Site Assessment (ESA).

1. Submission. The lender must submit a complete and final Phase I ESA with the pre-application or, if the pre-application stage is omitted, with the application for Firm Commitment along with the required documents listed in Section 9.2.A. 2-5. A summary submission is not acceptable. The lender must inform the ESA preparer of all of the following Phase I ESA requirements:
  - a. Purpose. The Phase I ESA will make an initial determination as to the presence of “hazardous substances” as defined by CERCLA, and of petroleum and petroleum products. In addition, a purpose of the Phase I ESA is to document compliance with 24 CFR 50.3(i), which states HUD’s policy that all properties proposed for use in HUD programs be free of hazardous materials, contamination, toxic chemicals and gases, and radioactive substances, where a hazard could affect the health and safety of occupants or conflict with the intended utilization of the property. This purpose must be described in the “Purpose” subsection to the

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<sup>3</sup> For contact information, please see [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/mfh/hsgmfbus/abouthubspcs](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/hsgmfbus/abouthubspcs).

required “Introduction” Section of the Phase I ESA. To meet this purpose, in addition to the standard Phase I determination of whether Recognized Environmental Conditions (RECs) have been identified in connection with the site, the Evaluation section’s discussion of Findings, Opinions, and Conclusions should state whether further investigation or corrective action is recommended to meet §50.3(i).

- b. **Format.** The Phase I ESA must be prepared in accordance with the requirements of ASTM E1527-13 “Standard Practice for Environmental Site Assessments, Phase I Environmental Site Assessment Process”. The Phase I ESA must utilize the table of contents and report format specified in Appendix X4. The Phase I ESA must incorporate a vapor encroachment screen performed in accordance with ASTM E 2600-10. The Phase I must clearly indicate that HUD is an authorized user of the report.
- c. **Timing.** The Phase I ESA must be conducted (meaning the earliest of the date of the site visit, records review documents, or interviews) within one-year of the submission to HUD. HUD may require updates or additional analysis in specific circumstances. A Phase I ESA that was conducted more than 180 days prior to the submission date to HUD, but within the allowable one year period, must be updated pursuant to Section 4.6 of ASTM E 1527-13. A Phase I ESA prepared more than one year prior to submission to HUD, even if updated within 180 days of being submitted, is not acceptable.
- d. **Preparer’s Qualifications.** The Qualifications section of the Phase I ESA must describe the preparer’s qualifications. The Environmental Professional preparing the Phase I ESA must meet all of the qualification requirements of Appendix X2 of ASTM E 1527-13 and must meet the license/certification, education and experience requirements of Section X.2.1.1(2)(i), (ii) or (iii) of Appendix X2 of ASTM E 1527-13.
- e. **Findings Section.** The Findings section of the Phase I ESA must list all known or suspect Recognized Environmental Conditions (REC), Controlled Recognized Environmental Conditions (CREC), Historical Recognized Environmental Conditions (HREC) and de minimis conditions (such as minor soil staining). The Findings section must also list Vapor Encroachment Conditions (VECs), likely VECs, and circumstances in which VECs cannot be ruled out.
- f. **Opinions Section.** The Opinions Section must discuss each finding from the Findings section and whether it is a REC pursuant to Section 12.6 of ASTM E 1527-13. The justification for any Finding deemed not to be a REC must be included in the Opinions section. If the ESA preparer cannot make a statement as to whether a condition is or is not a REC, the Opinion Section must state what information or further investigation would be deemed necessary to make such a determination. The ESA preparer must also identify any data gaps. When previous remediation has been performed or is ongoing, i.e., not yet an HREC at the proposed site, the Phase I ESA must fully discuss the extent of such remediation in this section of the Phase I ESA, including any involvement of LSTF Authorities. The Phase I preparer must justify whether such ongoing remediation should resolve any RECs or

undecided issues identified in the ESA. Note that even if the Environmental Professional preparing the Phase I ESA determines that a Finding does not rise to the level of a REC, HUD may determine that the finding is a business environmental risk that warrants Phase II investigation.

- g. **Conclusions Section.** The Conclusions Section must make a determination of whether a REC, including a CREC, exists on the site in accordance with one of the two quoted statements at Section 12.8 of ASTM E 1527-13.
- h. In addition to the standard Phase I determination of whether RECs have been identified in connection with the site, the Evaluation section's discussion of Findings and Conclusions should state whether further investigation or corrective action is recommended to meet 24 CFR 50.3(i).
- i. **User Provided Information Section.** The borrower, or the current property owner (if different from the borrower), shall complete the User Questionnaire(s) as per Appendix X3 of ASTM E-1527-13 which must be included in the "User Provided Information Section" of the Phase I ESA and the preparer must take into account any information provided in the preparation of the Phase I ESA.
- j. **Testing Not Required.** The Phase I ESA does not require sampling and testing which will be performed during the course of a Phase II ESA or as part of a remediation plan (see below). However it should reference and discuss any prior Phase II ESA performed in general accordance with ASTM E 1903-11 including whether a condition is a REC.
- k. **Vapor Encroachment Screen.** The Phase I ESA shall incorporate an initial vapor (a.k.a. gas) encroachment screen to determine if there is a potential for vapors to occur in the subsurface below existing and/or proposed on-site structures. Those hazardous substances may be petroleum and petroleum products that consist of volatile organic compounds (VOC), semi-volatile organic compounds (SVOC) and inorganic volatile compounds. The initial vapor encroachment screen shall be performed using Tier 1 "non-invasive" screening pursuant to ASTM E 2600 - 10 "Standard Guide for Vapor Encroachment Screening on Property Involved in Real Estate Transactions, Section 8". If the Tier 1 vapor encroachment screen determines that, as indicated in ASTM E 2600-10, Section 8.7.1, there is a "vapor encroachment condition" (VEC) which is the "presence or likely presence" of such vapors in the subsurface below existing and/or proposed on-site structures, a likely VEC, or that a VEC "cannot be ruled out", it must be deemed to be a REC for purposes of the Phase I ESA. Vapor encroachment screen analyses must be integrated within the body of the various sections of the Phase I ESA.
- l. **Lead-based Paint (LBP) Chips.** LBP chips that are not inside or part of a structure may be deemed to be a hazardous substance under CERCLA (see EPA document referenced at Section 9.3.C.1.c.iv, below). Therefore, if there is or was a structure on the site that was built prior to 1978, any evidence of paint chips not inside or part of any current structures must be discussed in the "Site Reconnaissance" section of the Phase I ESA, must be listed in the

Findings Section, and must be discussed further as to whether the paint chips are either a REC or a de minimis condition in the Opinions section.

- m. Previous Remediation. When previous remediation has been performed, or remediation is currently taking place, the Phase I ESA must fully document such remediation, including any involvement from LSTF Authorities.
- n. Evaluation of the ESA. The Phase I ESA will be evaluated by HUD to determine if the property is acceptable for the hazards reviewed. HUD may require additional information or a Phase II based on findings that indicate an unacceptable business environmental risk. Any Phase I ESA that identifies a REC will require a Phase II ESA, unless it can be determined from the Phase I ESA that corrective action is not feasible. If no corrective action is feasible, HUD may reject the property.

#### B. Phase II ESA.

- 1. Purpose. The purpose of the Phase II ESA is to ascertain within the requirements of ASTM E 1903-11, “Environmental Site Assessments: Phase II Environmental Site Assessment Process”, whether the RECs identified in the Phase I ESA have resulted in the presence of “hazardous substances” as defined by CERCLA, and/or of petroleum and petroleum products at levels that would exceed LSTF unrestricted criteria (de minimis levels). The Phase II ESA need not necessarily be a complete site characterization (total nature and distribution) of contamination, but must proceed to a point where it indicates the location of greatest concentration and risk, taking in consideration all of the Recognized Environmental Conditions (RECs) identified in the Phase I ESA.”
- 2. Timing. The Phase II ESA shall be submitted with the pre-application or, if the pre-application stage is omitted, with the application for Firm Commitment. It is recommended that lenders consult with HUD before a Phase II ESA is prepared.
- 3. When Required. A Phase II ESA is required if:
  - a. The Phase I ESA indicates that there is a REC; or
  - b. HUD requires a Phase II ESA for reasons that are described to the lender.
- 4. Exception to Submission Requirement. In some cases wherein it is obvious that remediation will be required, with HUD permission a separate Phase II ESA may be bypassed and instead incorporated within the “site characterization” segment of the remediation plan referenced in Section 9.3.C.1 below.
- 5. Standards to Use. The Phase II ESA is to be performed pursuant to the logic model of ASTM E 1903-11, Section 7, including developing the conceptual model and validation.
- 6. Report Format. The Phase II ESA must be prepared in accordance with the requirements of ASTM E 1903-11 using the table of contents and report format specified in Appendix X3.2 as amended by X3.3. Some of the steps that a Phase II assessor might perform may be intuitive in nature, but they nevertheless must be included in the report so as to ensure its scientific validity.

7. New Construction or Substantial Rehabilitation Projects using Pre-application. For new construction or substantial rehabilitation projects with a pre-application, the Phase II ESA, if required, shall be submitted by the lender with the pre-application and must be reviewed by HUD before an invitation letter is issued.
8. HREC. If the Phase I ESA indicates that there is a HREC, as described in ASTM E 1527-13, i.e., a hazard has been remedied and an LSTF Authority has issued a No Further Action (NFA) letter or similar approval, HUD may either deem the NFA as completion of the remediation or it may require a Phase II ESA and/or further remediation.
9. Nature and Extent of the Study. The Phase II ESA need not necessarily be a complete site characterization (total nature and distribution) of contamination, but must proceed to a point where it indicates the location of greatest concentration and risk. However, when the existence of elevated levels of contaminants is confirmed, a complete site characterization will be required as a first step in remediation per Section 9.3.C.1 below.
10. Vapor Encroachment/Vapor Intrusion. If it is determined that there is a potential for vapors to occur in the subsurface below existing and/or proposed on-site structures either identified from the Phase I ESA as a REC or from this or a prior Phase II ESA, the Phase II ESA shall include either a Tier 2 vapor encroachment screen (per ASTM E 2600-10, Section 9), a vapor intrusion assessment (VIA) pursuant to LSTF policy and/or procedure (as discussed in ASTM E 2600-10, Appendix X7.1), or go directly to a Tier 4 “mitigation” (per ASTM E 2600-10, Appendix X7.1 or 7.2).

If a Tier 2 screen was performed and it determined that there was a VEC, a likely VEC, or that a VEC could not be ruled out, either a vapor intrusion assessment (VIA) pursuant to LSTF policy and/or procedure or Tier 4 “mitigation” (per ASTM E 2600-10, Appendix X7.1 or X7.2) is required.

If a VIA was performed, any mitigation (or remediation) deemed necessary must follow LSTF policy and/or procedure.

11. Phase II Conclusion. The Phase II ESA must conclude that:
  - a. There are “hazardous substances” as defined by CERCLA, and/or of petroleum and/or petroleum products at levels that exceed LSTF unrestricted criteria and list any chemicals so found, or
  - b. No hazardous substances, petroleum or petroleum products have been identified above de minimis levels.
12. Off-site contamination conclusion. The Phase II ESA must indicate whether there is a risk of off-site contamination migrating on to the proposed site including if:
  - a. There is no known or perceived off-site contamination in the vicinity of the proposed site,

- b. It is unlikely that any known or perceived off-site contamination will migrate on to the site, or,
  - c. It is likely that known or perceived off-site contamination will migrate on to the site.
13. The Phase II ESA written report must describe how it conforms to any applicable LSTF requirements and must include a detailed, common language summary.
14. Exception of requirement for Phase II preparation and submission for ongoing remediation. A Phase II ESA is not required when remediation is ongoing to the point of not yet being an HREC (see Section 9.3.A.1.e, above), if the Phase I ESA preparer states that such remediation should resolve any RECs and undecided Phase I ESA issues, (see Section 9.3.A.1.f, above), and if the remediation plan preparer indicates that all of the Phase II ESA requirements have been met.

### C. Remediation Plans – General.

Remediation plans are required if the Phase II ESA concludes that hazardous waste or petroleum products are present at levels that exceed LSTF unrestricted (de minimis) criteria, and/or that it is likely that known or expected off-site contamination will migrate on to the site. The following requirements apply to all remediation plans:

#### 1. Complete site characterization.

- a. Anytime a site has been identified from a Phase I or Phase II ESA as having contamination (or contamination exposure pathways), be it vapor (gas), liquid, solid, dissolved, or non-aqueous phase liquid (NAPL), above LSTF unrestricted (de minimis) criteria, a complete site characterization (sometimes known as special site assessment report, a detailed Phase II ESA, or a Phase III ESA) must be prepared as the initial step of any remediation plan.
- b. It must determine the total nature and distribution of such contamination, exposure pathways, and potential receptors (a.k.a., a conceptual site model). However, if the remediation plan preparer determines that the Phase II ESA preparer has already determined the nature and distribution of such contamination, exposure pathways and potential receptors, then such determination shall be so indicated and the Phase II ESA shall be made a part of the remediation plan.
- c. It must be based on the appropriate combination of the following ASTM Practices and Guides, as determined by the remediator's environmental investigator. Lesser degrees of site assessments or non-conformance are not acceptable. For lead contaminated sites, refer to the listed EPA Handbook.
  - i. D 6235-04 (2010), "Practice for Expedited Site Characterization of Vadose Zone and Groundwater Contamination at Hazardous Waste Contaminated Sites"
  - ii. E 1689-95 (2014), "Standard Guide for developing Conceptual site models for Contaminated Sites"

- iii. E 1903-11, “Environmental Site Assessments: Phase II Environmental Site Assessment Process”
  - iv. E 1912-98 (2004), “Guide for Accelerated Site Characterization for Confirmed or Suspected Petroleum Releases”
  - v. EPA, “Superfund Lead-Contaminated Residential Sites Handbook”, 2003, available at <http://www.epa.gov/superfund/lead/guidance.htm>.
- d. The requirements of Section 9.3.C.2, 3, and 4 must be met.
  - e. It must discuss how it complies with the listed Practices or Guides and/or appropriate LSTF procedures, and with any LSTF regulatory requirements.
2. Any remediation studies and plans must be in the form of a report which includes a detailed, common language summary.
  3. The remediation plan preparer’s qualifications must be discussed in any remediation reports.
  4. The remediation plan must cover all relevant contaminant phases: vapor (gas), liquid, solid, dissolved, and NAPL.
  5. The remediation plan must require either the removal of contamination to LSTF unrestricted (de minimis) criteria pursuant to 9.3.D or incomplete removal of contamination to restricted residential levels in the form of a Risk-Based Corrective Action pursuant to 9.3.E.
  6. Any remediation studies and plans must be submitted to HUD with the pre-application or, if the pre-application stage is omitted, with the application for Firm Commitment. Evidence of approval of the remediation plan by the LSTF authority must be submitted with the Application for Firm Commitment. For lenders using the pre-application process, HUD will review remediation plans before an invitation letter is issued.
  7. If HUD determines that it is uncertain whether implementation of the remediation plan will meet the requirements of either 9.3.D or 9.3.E, the remedial work must be completed, including clearance testing, and the remediation itself must be approved, including issuance of any clearance and closure documents, by the LSTF authority prior to issuance of the Firm Commitment.
  8. If the extent and cost of removing the contamination can be definitively determined, and the cost of removing that contamination can be specified pursuant to a contract for remediation (see Section 9.4), HUD may allow a remediation plan that has been approved by the LSTF authority that:
    - a. Permits the remediation including site testing, any clearance and closure documents, and the approval by the LSTF, prior to Initial Endorsement, or
    - b. If the lender can show why it would be impractical to complete remediation prior to Initial Endorsement, permit the remediation including site testing, any clearance and closure documents, and the approval by the LSTF, prior to Final Endorsement and initial occupancy.

9. All residents living regularly and construction workers working regularly on site while remediation is taking place shall be informed of the remediation activities and protected from any potential contamination. This requirement must be a part of the remediation plan.
10. Remediation contract insurance. Unless HUD determines otherwise, the remediation contract shall require cost cap and reopener insurance coverages, copies of which are to be included in the remediation plan.
11. Ongoing Remediation. If remediation is taking place or has been completed but has yet to receive approval by the LSTF at the time of submission of the Phase I ESA, the remediation plan and all remediation studies shall be submitted, along with a detailed common language summary, at the same time as the Phase I ESA.

D. Remediation Plans – Complete Removal of Contamination.

1. Except for situations where Section 9.3.E (Remediation Plans Allowing for Incomplete Removal of Site Contamination) applies, the lender must submit a remediation plan designed to bring the contamination identified by a complete site characterization per Section 9.3.C.1 to LSTF unrestricted criteria (de minimis) levels, with no ongoing active or passive remediation. There must not be any need for engineering controls, institutional controls, or monitoring wells.
2. All of the requirements for Section 9.3.C must be met.
3. A remediation plan that involves control of off-site contamination per Section 9.3.G and/or Tier 4 vapor encroachment mitigation per Section 9.3.B.10 is not permitted under this section, but may be allowed under Section 9.3.E.

E. Remediation Plans – Incomplete Removal of Contamination.

1. If the costs are deemed to be exorbitant and/or the feasibility deemed impractical for remediation of on-site contamination to LSTF unrestricted criteria (de minimis) levels, or if there is known or expected offsite contamination that poses a risk to the project site, the remediation plan may allow for incomplete removal to LSTF restricted residential criteria levels.
2. Justification for incomplete removal of contamination must be submitted along with the remediation plan and must include documentation that shows that the cost of the incomplete removal of contamination, including any life cycle costs for Operation and Maintenance and any applicable enforcement requirements of LSTF authorities, are sufficiently below the costs of complete contamination removal, per Section 9.3.D above.
3. The corrective action must be a Risk Based Corrective Action (RBCA) based on the appropriate combination of:
  - a. The following ASTM Guides and Practices, as determined by the remediator's environmental investigator:
    - i. E 1689-95 (2014), "Standard Guide for developing Conceptual site models for Contaminated Sites"

- ii. E 1739-95 (2015), “Standard Guide for Risk-Based Corrective Action Applied at Petroleum Release Sites”
  - iii. E 1943-98 (2010), “Standard Guide for Remediation of Groundwater by Natural Attenuation at Petroleum Release Sites”
  - iv. E 2081-00 (2015), “Standard Guide for Risk-Based Corrective Action”
  - v. E 2091-11, “Standard Guide for Use of Activity and Use Limitations, Including Institutional and Engineering Controls”
  - vi. E 2435-05 (2015), “Standard Guide for Application of Engineering Controls to Facilitate Use or Redevelopment of Chemical-Affected Properties”
  - vii. E 2616-09 (2014), “Standard Guide for Remedy Selection Integrating Risk-Based Corrective Action and Non-Risk Considerations”
  - viii. E 2600-10, “Standard Guide for Vapor Encroachment Screening on Property Involved in Real Estate Transactions” For Lead Contaminated Sites, EPA, “Superfund Lead-Contaminated Residential Sites Handbook”, 2003, available at <http://www.epa.gov/superfund/lead/guidance.htm>.
- b. LSTF regulatory procedures may be followed in lieu of the ASTM Guides and Practices, as listed above, when the remediator’s environmental investigator determines they are equivalent to the ASTM standards or of greater stringency.
4. The RBCA must always meet the requirements of any LSTF regulatory authority for restricted residential criteria levels.
5. The RBCA report(s) must:
- a. Meet all of the requirements of Section 9.3.C;
  - b. Discuss how the remediation plan complies with the applicable ASTM Guides and Practices and/ or LSTF regulatory procedures as discussed in Sections 9.3.E.3, above;
  - c. Discuss how it meets or will meet all of the requirements of Section 9.3.E.6; and
  - d. Discuss how it meets or will meet all of the requirements of Section 9.3.F through J.
6. The RBCA must be supported by the applicable combination of:
- a. Engineering and Institutional Controls (EC/IC). An appropriate mix of engineering controls such as capping and slurry walls, and institutional controls such as protective covenants and access restrictions are usually required for all RBCAs, shall follow the guidance in ASTMs E 2435-05 (2015) and E 2091-11, and must indicate how it met these Guides. LSTF regulatory provisions may be followed in lieu of these ASTM Guides, as amended when the remediator’s environmental professional determines their equivalence. EC/IC may include:
    - i. Hard/Soft Cap Engineering Control. A hard cap EC, such as concrete, generally is required if any contamination will remain on the site after Final Endorsement. Unless the lender can

justify why a lesser depth to contamination would be protective of the health and safety of occupants, the depth of any remaining contamination should be greater than the deepest of the following:

- the depth of the foundations of any existing or proposed structures including sumps;
- the depth of any existing or proposed utilities on site; or
- five feet below the surface.

HUD may allow for a soft cap (e.g. dirt) if other engineering controls such as an impenetrable geotextile fabric are included. If EC are not required for a soft cap, IC is still required.

- ii. Slurry Wall or Equivalent Engineering Control. A slurry wall or equivalent type EC may be required to prevent offsite contamination from migrating onsite or to prevent onsite contamination from migrating onsite or offsite. If the Phase I and/or Phase II ESA determines that the likely existence of off-site contamination presents a risk to the site, such a slurry wall or equivalent type EC will be required.
  - iii. Monitored Natural Attenuation and Enhanced Passive Remediation (MNA/EPR). MNA/EPR such as by bio-augmentation where no additional active input is required and passive engineering controls such as a slurry wall may be allowed as part of the RBCA. In such cases, the LSTF authority must issue a conditional No Further Action Letter or similar approval. Monitoring wells pursuant to the above RBCAs and meeting the requirements of Section 9.3.F will be required to monitor the progress of the remediation. When MNA/EPR is part of the RBCA, the remediation may continue beyond Initial Endorsement provided that the LSTF authority has determined in writing that such undertakings would present no threat to health, safety or the environment.
  - iv. Vapor Encroachment/Vapor Intrusion Mitigation. If a VEC is present, a VEC is likely present, or a VEC cannot be ruled out, then mitigation as discussed in ASTM E 2600-10, Section 7.2 is required, unless a VIA has been, or will be, performed pursuant to LSTF policy and/or procedure. When remediation goes directly from a Tier 1 screen or a Tier 2 screen, such controls shall, where feasible, consist of a poured-on vapor barrier to be used in conjunction with active and passive venting systems.
  - v. IC regarding groundwater contamination, if applicable, must be put in place.
- b. Operations and Maintenance (O&M) Plans. Any time there is an EC/IC there must be an O&M plan which itself is an IC. The O&M plan must be approved by the LSTF authority, and must discuss any associated enforcement required by LSTF authorities. An O&M plan must be in place for management of all contamination remaining on the site and any controls thereof. If HUD determines that the mortgagor does not have sufficient capacity to manage the O&M

plan, the mortgagor must contract an appropriate servicer to do so. The O&M Plan must ensure maintenance of any engineering controls and assign responsibility for that maintenance. (See Section 9.4. for costing.).

- c. No Further Action Letter (NFA). The LSTF authority must issue an NFA, or similar approval, except that a conditional NFA may be allowed pursuant to MNA/EPR (see 9.3.E.6.a.iii). The LSTF authority must indicate in the NFA that the remediation that has taken place or will take place protects the health and safety of occupants and does not conflict with the intended utilization of the property. Usually, this will be satisfied by a statement that the remediation meets LSTF residential use standards. The NFA must be submitted to HUD pursuant to the timeline required by 9.3.C.7 and 9.3.C.8.
- d. Groundwater Requirement. A site is or will be otherwise acceptable if contamination exists in the groundwater after completion of remediation, if:
  - i. IC regarding the groundwater is/will be put in place, along with an O&M plan, approval by the LSTF authority, and any applicable enforcement requirements of LSTF authorities. The ICs must prohibit any and all uses of the groundwater;
  - ii. The highest anticipated levels of groundwater based on high groundwater and/or 100 year flooding events, are below the levels of any construction or potentially anticipated utility work unless it can be shown how such high groundwater levels will not modify the horizontal and vertical extent of contamination to such a degree that it could affect the health and safety of residents and workers; and
  - iii. Any vapors from groundwater and/or soils are shown not to present a significant risk pursuant Tier 1 vapor encroachment assessment, Tier 2 vapor encroachment assessment, VIA, or mitigation.
- e. Safety of and Disclosure to Residents and Workers. Any time contamination above de minimis levels is allowed to remain on site after initial occupancy and final closing, all maintenance workers who might perform activities that could compromise the EC/IC, construction workers, and building residents, etc. are to be informed of the general type and extent of contamination and the protective measures that have been taken. It would be up to residents to inform any of their visitors/guests of these conditions.
- f. Hazardous Substance Quantification. If any RBCA remediation plan identifies hazardous substances (listed in 40 CFR 302.4) that will remain on the property after Final Endorsement, such plan shall determine the quantity of such hazardous substances and whether it exceeds the levels indicated at 40 CFR 373.2(b). (This is a requirement under CERCLA that would apply to HUD at any, time that HUD might own the property or take over its management.).

#### F. Monitoring Wells, Flushing Wells, or Testing Wells.

- 1. General Requirements. The presence of a testing or monitoring well on the property does not bar the property from consideration for mortgage insurance. If a monitoring well is required to

confirm that contaminants have been removed to intended levels or that an MNA/EPR is working properly, EC/IC will be required until such time as contaminants are reduced to de minimis levels and a Final NFA letter is issued.

2. **Monitoring Well Protocols.** Monitoring protocols must be specified in the RBCA and monitoring must proceed until contaminants have been removed to intended levels or that passive MNA/EPR is working properly.
3. **Off-site Contamination – Acceptability.** If a monitoring well is required to determine if existing or assumed off-site contamination has migrated or might migrate on-site, the site is generally not acceptable unless associated EC/IC are put in place pursuant to a RBCA or unless the LSTF authority provides a statement that such off-site contamination would not present a risk to the health of the project’s occupants if it were to migrate on-site.
4. **Flushing Wells – Unacceptable.** In no case may Final Endorsement/initial occupancy take place when a flushing well is in operation or will be required.
5. **Testing or Monitoring Wells Ordered by LSTF.** A testing or monitoring well may also be placed on the property by order of the LSTF to test or monitor contamination on the site or from a neighboring site. If a monitoring well would be required or exists solely to monitor the general health of an aquifer used as a water supply or potential water supply, but not in relation to an existing or potential hazardous condition, this is not a bar to environmental approval. However, the lender must notify HUD if there is any current or intended placement of a monitoring or testing well.
6. **Non-operating Wells.** Non-operating wells are not a bar to environmental approval, but must be capped over and closed out pursuant to the appropriate LSTF authority.

#### G. Off-site Contamination.

If the Phase I and/or Phase II ESA determine that the existence of off-site contamination presents a risk to the site or the residents of the project and the sponsor has no control over the off-site locations of the contamination, the site is not acceptable unless such off-site contamination is subject to a RBCA meeting all of the requirements of Sections 9.3.C and E.

#### H. Escrow.

Any monitoring wells and engineering controls, such as caps or slurry walls, may warrant an escrow account to be established by the lender at Endorsement to offset the cost of any ongoing maintenance. See 9.4.C. for further discussion.

#### I. Waivers.

If a Regional Office intends to waive any of the requirements in this Section 9.3 that are not regulatory in nature, the advice of the Departmental and/or Housing Environmental Officer, or the applicable REO/FEO

in whose district the project is located, should be obtained before the waiver is granted to ensure that such waiver is in compliance with the environmental requirements of 24 CFR 50.3(i).

#### J. LSTF Approvals and Reviews.

Any approvals by an LSTF authority must be given directly by that authority and may not be given by a third party approved by that authority to act in lieu of the authority itself. Approvals by local authorities are only acceptable when such authority is acting under delegation from the State.

#### K. Unacceptable Sites.

A site over a former solid waste landfill/dump and/or Superfund (National Priorities List (NPL)) site is not acceptable for development unless the hazardous substances, petroleum, and petroleum products are completely removed or remediated to restricted residential standards and the site is delisted, or for an NPL site only, the Federal Agency with management authority over the site gives written approval of the site for residential usage.

### **9.4 HUD Staff Responsibilities in Reviewing Cases Requiring Remediation**

#### A. General Responsibilities.

The Department assumes greater risk any time that a Firm Commitment is issued on a contaminated site, which risk is even greater when a loan is on a site where complete removal of contamination is not possible, requiring monitoring possibly with continuous remediation techniques such as MNA/EPR. Therefore, HUD staff must exercise great care in the review process to assure that all reasonable measures are taken to mitigate HUD's risk exposure and that an accurate determination is made of any remediation costs that are included in the HUD-insured mortgage. Any special site assessment reports, Phase II or Phase III ESAs should be reviewed so that the extent of the contamination is fully understood. Although the lender is responsible for assuring that environmental remediation contractors are qualified and experienced, field staff must still review references and qualifications and are strongly encouraged to consult with an REO/FEO at the start of any remediation discussion.

#### B. Complete Removal of Site Contamination.

1. **Technical Reviews.** Trained Underwriting or Technical staff (often an Appraiser) is responsible for the review of all environmental documentation and for the preparation of the environmental review in HEROS - Form HUD-4128, which may be supplemented as needed to document the review and HUD's conclusions as to the adequacy of the proposed remediation plan.

Any estimates of value or rents should be made as if the project is unaffected by contamination and conditioned on successful removal. The appraisal must address any effect of marketability that may be present due to the prior environmental history.

2. **A/E and Cost.** A construction analyst should review the cost estimate of the remediation plan to determine whether it is reasonable and if the remediation and removal contractor is appropriately

bonded and qualified. Cost data for remediation is not as plentiful as with more routine construction tasks. “Environmental Remediation Estimating Methods” might be helpful in some cases and is available through RS Means at <http://www.rsmeans.com>. In addition, the A/E and Cost staff may consult with local environmental remediation professionals about costs for similar work.

3. Mortgage Credit. The HUD underwriter shall determine escrow, performance and bond payment requirements. The amount of the escrow or bond shall be based on the estimated cost of the mitigation work from the contractor, at 150% of the estimated cost. The cash requirements for the escrow or bond, and the lender and Mortgage Credits procedures for administering the escrow, shall be in accordance with existing closing instructions in the FHA Multifamily Program Closing Guide. Higher escrow or bonding requirements will be necessary if Multifamily Regional staff and/or the REO/FEO determine that there is a greater than average risk that unforeseen problems may arise, resulting in increased cost based on previous experience with similar work and/or research through local environmental remediation contractors about their experience in containing the cost within their stated estimate.

#### C. Incomplete Removal of Site Contamination.

1. HUD staff should follow the guidance in Section 9.4.B regarding initial removal or mitigation costs.
2. HUD staff must assure that the cost of any requirement for continuous monitoring and/or mitigation is accommodated. An escrow account established by the lender at Endorsement may be the most appropriate choice. This may also be accomplished by including the cost in Section E of the HUD-92264 under “Other Maintenance” and would include fees charged by service providers who are engaged to perform monitoring. If an expense is for actual or anticipated replacement of a component such as a pump, it should be included in the Reserves for Replacement. The basis for the expense or additional replacement reserve will be obtained from a qualified engineer and/or contractor. The engineer/contractor’s estimate should be sufficiently detailed and supported to allow review by the construction analyst as well as the appraiser.

Any effect on project marketability, value or rents due to the need for continuous monitoring/mitigation must be quantified and discussed in the appraisal.

#### D. Management, Coordination and Communication.

The Department assumes greater risk in cases involving environmental mitigation that will occur after Initial Endorsement especially when mortgage proceeds are used to fund the cost of remediation. Extra attention must be given to the need for frequent communication, preferably with written documentation, between disciplines that are coordinated by team leaders and Multifamily Regional Center Directors relating to levels of contamination, cost estimates and the certainty of the effectiveness of mitigation.

#### E. Insurance/Guarantee Requirements.

Borrowers are required to obtain separate insurance for environmental hazards from an insurer acceptable to HUD if remediation work will be done on the site during the insured loan period, if the coverage is available. Environmental hazard insurance typically covers liability and cost of completion.

The environmental remediation contractor will almost always be different from the project's general contractor. Aside from the contractor qualifications, licensure and bonding that are addressed above, the remediation contractor must provide HUD a separate guarantee of completion for their work on a form prescribed by HUD.

### **9.5 Environmental Report**

The lender must submit a narrative Environmental Report to provide information regarding compliance with the NEPA environmental factors, the laws and authorities listed at 24 CFR 50.4, and the HUD-specific requirements described herein, as applicable, as well as any issues that might affect the acceptability of the project, including any issues of compliance with state environmental laws. Each authority must be addressed, unless a CE applies (see 9.1.A.4 and 9.1.A.5, above) or an exception is otherwise noted below. If a CE or other exception applies, the application or Environmental Report must include a statement to that effect. The Environmental Report must include and appropriately cite supporting documentation. The failure to submit applicable supporting documentation may cause delays in the environmental review process.

The information below provides background information on some of these authorities; more information can be found in the authorities. The Environmental Report must be submitted at pre-application for those lenders using the pre-application process, or at the application for Firm Commitment stage for others. HUD may request additional data or studies to comply with these requirements.

The following environmental issues must be included as applicable:

- A. Lead-Based Paint
- B. Asbestos
- C. Radon
- D. Historic Preservation
- E. Floodplain Management
- F. Wetlands Protection
- G. Endangered Species
- H. Noise Analysis

- I. Explosive/Flammable Hazards
- J. Coastal Barrier Resources
- K. Coastal Zone Management
- L. Sole Source Aquifers
- M. Airport Clear Zones
- N. Environmental Justice
- O. Other Federal or State Laws
- P. Additional Hazards and Nuisances

The issues discussed in detail below must be analyzed by HUD staff during their preparation of the environmental review in HEROS - Form HUD-4128 and provide guidance by which the lender can assist HUD. These brief descriptions are not substitutes for the requirements in the statutes, regulations, Executive Orders, and handbooks. Note that “Toxic Chemicals and Radioactive Materials” should be included in the Phase I ESA discussed above.

A. Lead-Based Paint (24 CFR Part 35).

1. Lead-based paint requirements are applicable to multifamily housing constructed before 1978, in accordance with 24 CFR Part 35.

Exceptions:

- a. The project is proposed for demolition provided the property will remain unoccupied until demolition;
- b. The housing is designated exclusively for the elderly or persons with disabilities, unless a child of less than 6 years of age resides or is expected to reside there.
- c. Zero-bedroom dwelling units.

Exemption: An application for insurance in connection with a refinancing transaction where an appraisal is not required under the applicable procedures established by HUD.

2. HUD regulations regarding lead-based paint are found at 24 CFR Part 35, copies of which, along with guidance materials, may be downloaded from [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/healthy\\_homes](http://portal.hud.gov/hudportal/HUD?src=/program_offices/healthy_homes), or obtained by telephoning 1-800-424-LEAD. The helpful Lead Rule Compliance Advisor is available at <http://portalapps.hud.gov/CorvidRpt/HUDDLBP/welcome.html>.
3. For pre-1960 residential properties that do not involve conversions or major rehabilitation, the lead-based paint report shall consist of a risk assessment to identify lead-based paint hazards, performed in accordance with 24 CFR 35.1320(b), by a certified lead-based paint risk assessor. Any identified

lead-based paint hazards must be treated with “interim controls” in accordance with 24 CFR 35.1330 and shall be considered to be completed when clearance is achieved in accordance with 24 CFR 35.1340. Interim controls generally should be completed prior to issuance of the Firm Commitment, but with HUD approval, may be completed prior to Final Closing under conditions in the Firm Commitment which require an escrow of sufficient repair or rehabilitation funds. Before the issuance of the Firm Commitment the sponsor shall agree to incorporate ongoing lead-based paint maintenance into regular building operations and maintenance activities in accordance with 24 CFR 35.1355(a). See 24 CFR 35.620.

4. For multifamily properties constructed after 1959 and before 1978 that do not involve conversions or major rehabilitation, before the issuance of the Firm Commitment the sponsor shall agree to incorporate ongoing lead-based paint maintenance practices into regular building operations in accordance with 24 CFR 35.1355(a). See 24 CFR 35.625
  5. For conversions and major rehabilitations (defined as “rehabilitation that is estimated to cost more than 50% of the estimated replacement cost after rehabilitation”), a “lead-based paint inspection” to identify the presence of lead-based paint shall be performed in accordance with 24 CFR 35.1320(a), by a certified lead-based paint inspector. The Firm Commitment shall require that any lead-based paint identified on the property shall undergo “abatement” in accordance with 24 CFR 35.1325 with the abatement to be completed prior to both initial occupancy and Final Closing. HUD will generally require that such abatement be achieved through paint removal or component replacement. However, if the sponsor can demonstrate that paint removal or component replacement is not practicable because the substrate material is architecturally significant and would be damaged by so doing, HUD may approve permanent encapsulation or enclosure and incorporation of ongoing lead-based paint maintenance into regular building operations maintenance activities. Abatement is considered complete when clearance is achieved in accordance with 24 CFR 35.1340. See 24 CFR 35.630.
  6. If an evaluation or hazard reduction is undertaken, the sponsor shall provide a notice to occupants in accordance with 24 CFR 35.125. The sponsor shall also provide the lead hazard information pamphlet in accordance with 24 CFR 35.130.
  7. The cost of lead-based paint abatement or hazard control work may be included in the proposed mortgage loan with HUD approval.
  8. Most sale and rental transactions are also subject to the HUD-EPA lead-based paint disclosure rules at 24 CFR Part 35, Subpart A.
- B. Asbestos (24 CFR 50.3(i)).
1. While many uses of asbestos are technically allowed today, several uses of asbestos have been banned starting in the early 1970s, and many commercial enterprises may have stopped installing asbestos products as of the late 1970s. Some of the more common examples of asbestos containing materials include insulation, sprayed on finishes, such as ceilings, vinyl floor tile and the adhesive to fix the tile in place, siding, and roofing. Asbestos studies and information must be

included in the Environmental Report, in accordance with HUD's environmental policy articulated at 24 CFR 50.3(i), that properties proposed for use in HUD programs be free of hazardous materials, contamination, toxic chemicals and gasses, and radioactive substances, where a hazard could affect the health and safety of occupants or conflict with the intended utilization of the property.

2. For any structures on the site built before 1978 which are to be demolished, a comprehensive building asbestos survey by a qualified asbestos inspector is required. It must be performed pursuant to the "pre-construction survey" requirements of ASTM E 2356-10, "Standard Practice for Comprehensive Building Asbestos Surveys".
3. Other than for structures to be demolished, on any building built before 1978, a qualified asbestos inspector must perform a comprehensive building asbestos survey pursuant to the "baseline survey" requirements of ASTM E 2356-10, "Standard Practice for Comprehensive Building Asbestos Surveys". In those cases where suspect asbestos is found, it should either be assumed to be asbestos or should require confirmatory testing.
4. If there is asbestos and it is friable or damaged, HUD requires that it be removed. If asbestos is not friable or damaged, HUD strongly recommends that at a minimum it be encapsulated, which would be incorporated in an O&M plan.
5. The asbestos survey must be submitted with the application as part of the Environmental Report. If the survey identifies asbestos or asbestos is assumed, HUD will condition the Application for Firm Commitment on an appropriate mix of asbestos abatement and an asbestos O&M plan.
6. Other than for asbestos abatement on a structure that will be completely demolished, the cost of any asbestos abatement activities may be included in the proposed mortgage loan.
7. All asbestos abatement shall be done in accordance with EPA requirements for air pollution prevention pursuant to 40 CFR, subpart M especially, 40 CFR 61.145 and OSHA requirements for Worker Protection, pursuant to 29 CFR 1926.1101, and any LSTF asbestos abatement and worker protection rules. All asbestos abatement must be performed by a qualified asbestos abatement contractor.

#### C. Radon (supersedes ML 2013-07)

1. Background. One common constituent of soil and rock is the unstable element uranium. One of the decay products of uranium is radon, a colorless, odorless gas. Under certain natural conditions, the radon gas can enter surface soils and become part of the "soil gas" environment, which then can enter the air, including air inside of buildings. When soil gas that contains radon enters a building, radon and its decay products are either directly inhaled, or attached to dust on walls, floors and in the air, which then can be inhaled. These decay products then undergo further decay, resulting in

the release of subatomic alpha particles. This alpha particle radiation can cause mutations in lung tissue which can lead to lung cancer. The risk of contracting lung cancer from radon increases with an increase in the concentration of radon in the air that is breathed by building occupants. EPA recommends mitigation for residences with radon concentrations at or above 4 picocuries per liter of air (pCi/L).

## 2. General Requirements.

### a. Radon Report.

- i. The radon report is required for all applications, unless an exception listed in Section 9.5 C.2.c. applies.
- ii. The radon report shall be included in the pre-application, or application, as applicable.
- iii. Contents. The radon report shall include the results of any testing performed, the details of any mitigation deemed necessary, and the timing of any such mitigation. An amended radon report must be issued if the testing and/or mitigation must occur after application submittal according to the requirements below. The radon report must be signed and certified as to its compliance with the requirements of this section by a Radon Professional.

### b. Radon Professional.

- i. All testing and mitigation must be performed under the direct supervision of a Radon Professional, in accordance with the protocols referenced in this section.
- ii. Radon Certification/License of the Radon Professional is required as follows:
  - a. Certification from either the American Association of Radon Scientists and Technologists (AARST) National Radon Proficiency Program (NRPP) or the National Radon Safety Board (NRSB); and
  - b. Certification/License from the state in which the testing or mitigation work is being conducted, if the state has this requirement.

### c. Exceptions to Radon Report.

- i. A Radon Professional may conclude that neither testing nor mitigation is necessary based on a physical inspection of the property, the characteristics of the buildings, and other valid justifications. An example of a valid justification is having only a garage on the surface level that is open to the air and is fully ventilated. Any such justifications as to why neither testing nor mitigation is necessary must be provided in the Environmental Report. Any waiver requests submitted for this section (9.5.C) must be made in accordance with this exception. Requests for waiver of this section 9.5.C that do not meet

the requirements of this exception will not be granted.

- ii. A radon report is not required for Section 223(f) project applications that have a low radon risk. To determine whether the project's radon risk is low, the lender must first establish that the project is located Zone 3 of the EPA Map of Radon Zones (available at: <http://www.epa.gov/radon/zonemap.html> ). Then the lender must consult any published and readily available state or local radon potential data or maps to confirm the radon risk is low. If such information indicates a low radon risk, the lender must provide appropriate documentation.
  - iii. A radon report is not required for applications that are categorically excluded under 24 CFR 50.19(b)(21) (see 9.1.A.5, above).
  - iv. Applicants are encouraged to test for radon even if a radon report is not required per the exceptions above. Any such testing must follow the testing protocols and resident notification protocols below, and must then be incorporated within a radon report as described within this section. If the results of such testing indicate levels of radon above the threshold for unacceptability, mitigation as described in this section is required, with the mitigation requirements for Section 223(a)(7) projects the same as those for 223(f) projects.
- d. Testing Protocols.
- i. Radon testing must follow the protocols set by the American Association of Radon Scientists and Technologists, Protocol for Conducting Radon and Radon Decay Product Measurements in Multifamily Buildings (ANSI-AARST MAMF-2012, Section III, or similar section in the most recent addition) (available at <http://aarst.org/bookstore.shtml>).
- Exception: With reference to Section III.3.1 of ANSI-AARST MAMF-2012, the minimum number of areas to be tested shall be at least twenty-five percent of randomly selected ground level units/rooms in each building. All of the other requirements at Section III.3 of ANSI-AARST MAMF-2012, including upper floor testing, shall be followed. Note that if less than one-hundred percent (100%) of ground level units/rooms are tested and radon is found in one or more unit/room at or above threshold requirements, then all ground level units/rooms must be mitigated.
- ii. Threshold for unacceptability: 4.0 picocuries per liter (4.0 pCi/L) based on initial and any confirmatory testing, if performed.
- e. Occupant Notification.
- i. Testing. Occupants of all new applications for Multifamily MAP and TAP mortgage insurance programs shall be informed of forthcoming testing in the manner described in AARST MAMF-2012, Section II.B and Section III. 2.2.1.

- ii. Mitigation. Occupants shall be informed both prior to and after mitigation activities. In the case of new construction, incoming occupants shall be informed of radon mitigation activities.
- f. Mitigation Standards. Radon resistant construction is required for all new construction, and radon mitigation is required for existing construction where testing has revealed that radon levels exceed the threshold for unacceptability. The Radon Professional must assure that radon resistant construction or radon mitigation, when required, conforms to the following standards.
  - i. Existing buildings:
    - a. Multifamily structures: ANSI-AARST RMS-MF 2014, Radon Mitigation Standards for Multifamily Buildings (available at <https://www.aarst.org/bookstore.shtml>).
    - b. Single Family structures: ASTM E2121-13 (or most recent edition), Standard Practice for Installing Radon Mitigation Systems in Existing Low-Rise Residential Buildings (available at <http://www.astm.org/Standards/E2121.htm>).
  - ii. New construction: ASTM E1465-08a, Standard Practice for Radon Control Options for the Design and Construction of New Low-Rise Residential Buildings (available at <http://www.astm.org/Standards/E1465.htm>).
- g. Mitigation Timing. For new construction and substantial rehabilitation properties, all mitigation, including follow-up testing, must be completed prior to Final Closing. Radon mitigation included as part of a Section 223(f) project's repairs must be completed as quickly as practicable, and in any event, no later than 12 months after Closing.
- h. Certificate of completion. A certificate of completion from the Radon Professional must be submitted and appended to the radon report once radon testing and/or mitigation is completed.
- i. Cost estimate. Use detailed plans and specifications supplied by the lender's architectural analyst as required by MAP Guide, Section 5.11, as a basis for the cost estimate. Estimates must reflect the general level of construction costs in the locality where construction takes place. Costs must be projected to the estimated construction start date.

### 3. Section 223(f).

- a. All Section 223(f) projects located within high risk (Radon Zone 1) and medium risk (Radon Zone 2) zones must be tested for radon in accordance with 9.5.C.2.d, above.
  - i. Testing must be performed no earlier than 1 year prior to application submission.
  - ii. Exception: The applicant may elect to proceed directly to mitigation without testing.

- b. Mitigation. See requirements at 9.5.C.2.f. If estimated costs exceed the allowable cost for the Section 223(f) program, the application cannot be approved but may be considered under the substantial rehabilitation program.

#### 4. Substantial Rehabilitation and Conversions.

(Applies to all Radon Zones)

- a. Testing prior to substantial rehabilitation or conversion.
  - i. Early testing not feasible. For some proposals, such as a conversion of an existing building from non-residential to residential, the building envelope may change to such an extent that early testing would not be appropriate and in some cases not possible. If this is the case, proceed directly to mitigation as discussed at Section 9.5.C.4.b.
  - ii. Early testing when feasible.
    - a. Must be performed no earlier than 1 year prior to application submission in accordance with 9.5.C.2.d.
    - b. If test results are below the threshold, no mitigation is required.
    - c. If test results are at or above the threshold, mitigation must be built into the project design per Section 9.5.C.4.b.i.
- b. Mitigation.
  - i. If mitigation is built into project design, it must be conducted in accordance with the requirements at 9.5.C.2.f.
  - ii. If mitigation is not built into project design, after construction is complete but prior to Final Closing, radon testing must be conducted. If testing results are above the threshold, retrofit pursuant to the requirements at 9.5.C.2.f is required.

#### 5. New Construction.

- a. Radon resistant construction is required for all radon zones.
- b. Radon Zone 1:
  - i. Construction Requirements: All new construction in Radon Zone 1 must meet all of the requirements of ASTM E1465-08a for installation of passive systems.
  - ii. Post-construction testing is required prior to Final Closing. If testing results are above the threshold, conversion from a passive system to a fan-powered system is required.

c. Radon Zones 2 and 3:

i. Construction requirements.

- a. Gas permeable layer. The gas permeable layer must meet all of the requirements of ASTM E1465-08a, Section 6.4.
- b. Ground cover. The concrete slabs and plastic membranes that seal the top of the gas permeable layer must meet all of the requirements of ASTM E 1465-08a, Section 6.2.
- c. Foundation walls. Foundation walls must meet all of the requirements of ASTM E1465-08a, Section 6.3.

ii. Post construction testing is required, except as provided at 9.5 C.2.c.

- a. Radon testing must be performed after construction is complete, but prior to Final Closing.
- b. If testing results are above the threshold, retrofit based on the applicable standard at 9.5.C.2.f is required, with installation of a passive system. If testing results remain above threshold, a fan-powered system is required.

D. Historic Preservation (24 CFR 50.4(a)).

1. HUD must follow the procedures implementing the National Historic Preservation Act (54 U.S.C. 300101 et seq.) with regulations found at 36 CFR Part 800. Section 106 of the National Historic Preservation Act (NHPA) requires Federal agencies to take into account the effects of their undertakings on historic properties and to afford the Advisory Council on Historic Preservation a reasonable opportunity to comment.
2. Applications for Firm Commitment, whether for new construction, rehabilitation, refinancing or conversion from non-residential to residential property are considered “federal undertakings” which require HUD to make a determination of no historic properties affected, no adverse effect, or adverse effect upon historic properties. An historic property means any prehistoric or historic district, site, building, structure, object, or traditional property or landscape included in, or eligible for inclusion in, the National Register of Historic Places maintained by the Secretary of the Interior. Also, HUD must consider the area of potential effect (APE), which is often the site boundary, but occasionally the block on which the site is located or the immediate site environs.

Exceptions (if applicable, a statement identifying the exception and supporting documentation must be included in the application):

- a. Categorical exclusions under 24 CFR 50.19(b)(21) (see 9.1.A.4, above);
- b. HUD has made the determination that 223(f) refinance transactions that will not allow

rehabilitation nor result in any physical impacts or changes except for routine maintenance have “no potential to cause effects” to historic properties, as described in 36 CFR 800.3(a)(1), and therefore have no further obligations under Section 106 of the Historic Preservation Act or 36 CFR Part 800. For such transactions, the lender is not required to contact the State Historic Preservation Officer (SHPO), and HUD staff historic preservation responsibilities are limited to documenting this determination in the form HUD-4128;

- c. Some states may have a Programmatic Agreement (PA) with HUD and the proposal may be part of a class of actions that do not require Section 106 consultation under the PA.
3. Pursuant to the “anticipatory demolition” requirements of Section 110(k) of the National Historic Preservation Act (54 U.S.C. 306113), even before the concept meeting or application submission takes place, any action by a potential lender or borrower, or any action by another party that the lender or borrower has the legal power to prevent, that is taken with the intent to circumvent Section 106 review and that significantly adversely affects a historic property, could result in rejection of an application.
  4. If an exception does not apply, HUD must review the project and make a finding of effect. The lender may assist HUD in making its historic preservation determinations by submitting a preliminary letter to the appropriate SHPO consisting of a narrative explaining the proposal, and following the procedures outlined by the individual SHPO office. The letter must include a description of the proposed site activities, a map identifying the site location, the APE, and a preliminary opinion as to whether the proposal would have any effect on historic properties. The letter, any referenced documentation, and the SHPO response, if any, must be included in the environmental report. Lenders may obtain from the HUD office the name and address of the SHPO who has the right to comment on the proposal. If a response from the SHPO is not received within 30 days, the lender must alert HUD of this fact in their application. Some SHPOs will only respond to Federal agencies. Note that HUD, not the lender, is responsible for contacting the Tribal Historic Preservation Officer (THPO) and any affected tribes (see 36 CFR 800.2 and 800.3). The information contained in the letter that was submitted to the SHPO as described above will assist HUD in carrying out its tribal and THPO consultations.
  5. Because of the technical nature of historic property identification, evaluation and treatment, it may be appropriate to retain a qualified historic preservation professional to prepare the letter. Such consultant should meet the Secretary of the Interior’s Professional Qualifications (36 CFR Part 61) and have experience in Section 106 reviews. Examples of when retention of a qualified historic preservation professional may be appropriate include when National Register eligibility of a property is unclear, when adverse effects are expected, when the property contains archeological sites, and/or when the project is controversial.

6. After a SHPO response has been received or 30 days have elapsed, the lender provides the response to HUD and HUD must make a final determination of effect. HUD will review the SHPO letter and other information for sufficiency, invite consulting party participation as appropriate, and if appropriate may request additional information or engage in further consultation with the SHPO. If HUD determines there is that there are no Historic Properties Affected by the project, it will notify the SHPO/THPO. If the SHPO/THPO (or the Advisory Council for Historic Preservation, if it enters the Section 106 process) does not object within 30 days, a commitment may be issued. Where an undertaking will affect a historic property or historic district, HUD will direct the consultation process, which may result in a design change, research and preservation, salvage, or in rare cases, rejection of the application for Firm Commitment. Consultation may take considerable time, and must occur before a commitment can be issued.

7. Tribal Consultation:

- a. When Section 106 consultation is required, consultation with federally recognized Indian tribes and Native Hawaiian Organizations may be required. Not all projects that require Section 106 review require consultation with Indian tribes. Consultation with federally-recognized tribes is only required when a project includes activities that have the potential to affect historic properties of religious and cultural significance to tribes. These types of activities include:
  - i. ground disturbance (digging),
  - ii. new construction in undeveloped natural areas,
  - iii. introduction of incongruent visual, audible, or atmospheric changes,
  - iv. work on a building or structure with significant tribal association, or
  - v. transfer, lease or sale of historic properties of religious and cultural significance.
  
- b. When tribal consultation is required, the HUD reviewer will utilize the HUD Tribal Directory Assessment Tool (<http://egis.hud.gov/tadat/Tribal.aspx>) during the environmental review process to determine if the site is located in an area of tribal significance. The tribal consultation requirement applies to properties *off* tribal lands as well as on tribal lands. Properties with religious and cultural significance to native people may include ancestral archaeological sites and natural areas where traditional practices or ceremonies have been carried out as well as more familiar historic properties. Some traditionally used places have very strong religious associations, and it may be difficult or even inappropriate for native people to talk about their significance. If this situation arises, hiring a qualified professional with experience in tribal consultation may be required. The cost of such an interpreter shall be paid by the borrower.

8. The Section 106 review must be completed before HUD approves and/or commits funds to a project. Additional guidance on historic consultation is available at:

<https://www.hudexchange.info/programs/environmental-review/historic-preservation> and  
<http://www.achp.gov/work106.html>.

9. The cost of historic preservation mitigation may be included in the proposed mortgage loan.

E. Floodplain Management and Flood Insurance (24 CFR 50.4(b)(1) and (2))

1. Applications for Firm Commitment are subject to regulations regarding floodplain management found at 24 CFR Part 55 which implements Executive Order 11988 (Floodplain Management). The lender must utilize the Federal Emergency Management Agency's best available data to comply with Floodplain Management requirements, which is typically the latest issued Advisory Base Flood Elevations (ABFEs), Preliminary Flood Insurance Rate Maps (P-FIRMs), or Flood Insurance Rate Maps (FIRMs) so long as the ABFE or P-FIRM does not have a lower elevation requirement than the enacted FIRM. The relevant Flood Insurance Rate Map (FIRM) may be found on line at: [www.msc.fema.gov](http://www.msc.fema.gov) . An on line resource for checking ABFEs in Region 2 can be found at: <http://www.region2coastal.com/sandy/abfe>. If any part of the site or integral offsite development (i.e., ingress, egress and/or parking) is located within the 100-year floodplain (1% chance of annual flood, known as the Special Flood Hazard Area) or within a 500-year floodplain (0.2% chance of annual flood) for critical actions, according to the best available data, the project must comply with HUD's floodplain management regulations.
2. An application for mortgage insurance shall not be approved for a property located in: (a) a floodway; (b) a coastal high hazard area (generally listed as "V" zones on Flood Insurance Rate Maps); or (c) a FEMA identified special flood hazard area in which the community has been suspended from or does not participate in the National Flood Insurance Program. The terms "critical action," "coastal high hazard area," "floodway," and "functionally dependent use" are defined at 24 CFR 55.2. If a stream coursing through a proposed site is designated as being in the 100-year floodplain according to FEMA's best available data, but there is no designated floodway area (a so-called "regulatory floodway"), development will be prohibited in the channel of the stream.

Exceptions:

- a. 24 CFR 55.12 lists categories of proposed actions for which the floodplain management requirements in 24 CFR 55 are not applicable. The floodway and coastal high hazard area prohibitions do not apply if only an incidental portion of the project is in the 100-year floodplain, or for critical actions, the 500-year floodplain, and certain conditions are met (see 24 CFR 55.12(c)(7)). HUD does not consider improvements to be incidental.
- b. When invoking the incidental portion exception at 24 CFR 55.12(c)(7), a protective covenant or comparable restriction must be placed on the property's continued use to preserve the floodplain. The covenant or comparable restriction must run with the land to provide for

permanent preservation of the floodplain. A restriction that is contained in a document that would expire at the conclusion of the HUD-insured mortgage does not meet the requirement for permanent preservation of the floodplain.

In considering the safety of the residents, offsite floodways and other flood hazards will be evaluated in terms of separation distance, elevation differences, and the nature of the hazard in question. Unacceptable proximity to hazards may result in rejection of the application.

- c. Refinances of currently HUD-insured mortgages are exempt from the 24 CFR Part 55 when the refinance will not result in any physical impacts or changes except for routine maintenance under 24 CFR 50.19(b)(21). However, the flood insurance requirements specified at 24 CFR 50.4(b)(1) are still applicable.
3. Projects that are converting from a non-residential to a residential use are considered the same as “new construction” for floodplain management
  4. New construction and substantial improvement, as defined at 24 CFR 55.2(b)(10), in mapped 100-year floodplains is strongly discouraged. This flood buffer zone is extended to the 500-year floodplain for proposed rehabilitation, refinancing, or new construction for facilities housing or serving mobility-impaired individuals, a critical use. Such sites in the applicable floodplain according to the best available data will not be considered for mortgage insurance unless one of the following steps is taken:
    - a. A Conditional Letter of Map Amendment (CLOMA) or of Map Revision (CLOMR) removing the entire site from the applicable floodplain has been obtained from FEMA prior to submission of the pre-application or, in the absence of a pre-application, prior to submission of the application for Firm Commitment. If the borrower has a CLOMA or CLOMR, HUD approval for a Firm Commitment will be conditioned on the borrower: (1) meeting the requirements of the CLOMA or CLOMR; (2) obtaining a Final Letter of Map Amendment (FLOMA) or MAP Revision (FLOMR) removing the entire site from the applicable floodplain prior to Final Endorsement; and, (3) maintaining flood insurance on any building during the construction period until the FLOMA or FLOMR is issued; or
    - b. If Section 9.5.E.4.a does not apply, HUD must determine if there may be extraordinary circumstances which lead to the conclusion that there are no practicable alternatives to the project site being in the floodplain. In order to make this determination, HUD must conduct an 8-step decision making process which includes publishing two public notices and taking comments, as summarized in 24 CFR 55.20. Prior to issuing the first public notice, HUD will require detailed information about how the property will be altered and improvements designed. This information includes the elevation of the property, the elevation of the floodplain, and the location of life support systems.
      - i. Except in circumstances where it would not be practicable, in order to minimize adverse impacts, the 8-step process shall require as a condition of any project approval that a CLOMA or CLOMR be issued prior to initial endorsement, a FLOMA or FLOMR be issued prior to Final Endorsement, and flood insurance be maintained on any building during the construction period until the issuance of the FLOMA or FLOMR.

- ii. The 8-step process shall require that the lowest floor of new construction be elevated at or above the Base Flood Elevation of the applicable floodplain based on the best available FEMA data, plus one foot of freeboard. However, in no event shall the lowest floor be below the Base Flood Elevation on the current adopted Flood Insurance Rate Map.
  - iii. The 8-step process requires that all “critical actions” as defined in 24 CFR 55.2(b) (3) must comply with the requirements of 24 CFR 55.20(e).
  - iv. Instead of elevating non-residential or mixed use structures that are not critical actions, the project may be designed and constructed such that below the flood level, the structure is non-residential and flood proofed to the level of the best available flood data plus one foot. Flood proofing requires structures to be water tight with walls substantially impermeable to the passage of water and with structural components having the capability of resisting hydrostatic loads, hydrodynamic loads, the effects of buoyancy, or higher standards required by the FEMA National Flood Insurance Program as well as state and locally adopted codes.
  - v. The 8-step process shall be completed by HUD before issuance of the Firm Commitment. HUD will develop the two notices, but the costs of publication will be borne by the borrower.
5. For purchase or refinancing actions described in 24 CFR 55.12(a)(2) or repair, rehabilitation, modernization or improvement actions described in 24 CFR 55.12(a)(3), an abbreviated process pursuant to 24 CFR 55.12(a) may be used by the Hub or PC to determine their acceptability. Detailed information about the proposed actions, and about any plans for mitigation, must be submitted an application phase. HUD will evaluate risks and mitigation measures in making its decision. HUD discourages these actions if the lowest floor and/or the life support facilities, or egress and ingress of the existing building, are more than 12 inches below the 100-year floodplain line. The abbreviated review process shall be completed by HUD before issuance of the Firm Commitment.
6. Where a site does not appear to be located in the floodplain on official FEMA maps, but shows evidence of flooding or has a history of flooding, HUD is not precluded from qualitatively evaluating the acceptability of the site. Lenders will be required to provide extensive data to aid HUD in evaluating previously flooded or floodplain sites.
7. Any building accepted that is located within a FEMA mapped special flood hazard area is required to carry flood insurance under the National Flood Insurance Program for the term of the loan, in an amount at least equal to the least of the development or project cost less estimated land value, the outstanding principal balance of the loan, or the maximum available coverage. At the time of Application for Firm Commitment, the lender must submit a completed Standard Flood Hazard Determination Form with proof that the new mortgagor has a commitment for flood insurance effective as of loan closing. All new and renewal leases must contain acknowledgements signed by residents indicating that they have been advised that the property is in a floodplain and flood insurance is available for their personal property for sites within the 100-year floodplain and critical actions within the 500-year floodplain.

8. The cost of floodplain mitigation may be included in the proposed mortgage loan.

F. Wetlands Protection (24 CFR 50.4(b)(3))

1. Applications for Firm Commitment for new construction are subject to regulations regarding wetlands at 24 CFR Part 55, which implement Executive Order (EO) 11990 “Protection of Wetlands”. EO 11990 prohibits the development or disturbance of wetlands and proposals impacting wetlands unless there is no practicable alternative and the proposed action includes all practicable measures to minimize harm to the wetland. Proposals impacting wetlands must be reviewed by HUD to determine compliance with HUD–wetland protection policy. Wetlands include those identified on the National Wetland Inventory maintained by the U.S. Fish and Wildlife Service.
2. Extensive data must be provided in the Environmental Report to aid HUD in evaluating wetland impacts and the lender should consult early with the field office on any application for Firm Commitment on a site that impacts wetlands. HUD may require that the lender submit a wetlands delineation performed by a qualified professional to evaluate the direct and/or indirect wetland impacts of the project. Appropriate and practicable compensatory mitigation is recommended for unavoidable adverse impacts to more than one acre of wetlands. Compensatory mitigation includes, but is not limited to: permittee-responsible mitigation, mitigation banking, in-lieu fee mitigation, the use of preservation easements or protective covenants, and any form of mitigation promoted by state or Federal agencies.
3. New construction projects on land listed in the inventory will be considered only after HUD conducts an 8-step decision-making process which is the same as used for the flood plain process and includes consultation, issuing two public notices and taking public comment. Wetlands under local or state jurisdiction are subject to state or local review as appropriate. However, compliance with state or local requirements is not a substitute for the eight-step process.
4. Only in rare cases will rehabilitation, purchase and refinancing proposals be permitted to involve wetlands impacts.

G. Endangered Species (24 CFR 50.4(e))

1. Under Section 7 of the Endangered Species Act, HUD must consult with the U.S. Fish and Wildlife Service or the National Marine Fisheries Service (the Services) whenever a proposal may affect an endangered or threatened species or its habitat. A required consultation should be assumed for any site within the critical habitat (as defined in 50 CFR Part 17 and Part 226) of a listed species; consultation may also be required even if no critical habitat is present.
2. In areas where impacts on endangered or threatened species are a concern, all appropriate information regarding possible impacts of the project should be provided to HUD as early as possible. The Environmental Report should include review of published information, including but

not limited to information on the Services websites regarding the possible presence and associated critical habitat of any listed species in the vicinity of the proposal and provide HUD with the results of the research. Furthermore, if a proposal is in an area of potential impacts on a listed species or its critical habitat, any possible associated impacts caused by the proposal should be discussed in the Environmental Report. The lender and/or Environmental Report preparer should not contact the Services directly.

3. If the project activity could affect an endangered/threatened species or its habitat, HUD must make a determination of effect. HUD must seek concurrence of the Services on any “may affect, not likely to affect” determination and associated mitigation measures. HUD must initiate formal consultation under Section 7 of the Endangered Species Act for a “may affect, likely to adversely affect” determination. The lender may be required to obtain special studies such as habitat assessments, surveys or biological assessments at the borrower’s cost.
4. Consultation under Section 7 of the Endangered Species Act may result in more stringent conservation measures than would otherwise be imposed. The Regional staff can advise the lender where information on endangered species may be obtained.
5. The cost of mitigation to accommodate endangered species would likely be deducted from the warranted price of the land as an unusual site condition.

H. Noise (24 CFR Part 51, Subpart B)

1. HUD standards regarding the acceptability of noise impacts on residential property are found at 24 CFR Part 51 Subpart B, which standards must be met for new construction and conversion from nonresidential to residential projects. Where threshold criteria are met or exceeded for new construction or major/substantial rehabilitation, a noise analysis utilizing the methodology in HUD’s Noise Guidebook (HUD- 953-CPD) will be performed by HUD as part of HUD’s NEPA environmental assessment. The Regional staff should be consulted prior to attempting to design mitigation measures.
2. New construction or conversions of existing structures to residential housing in the Unacceptable Noise Zone, where outdoor noise levels are above 75 dB, are generally prohibited. If the Regional Office wants to consider such a proposal, it must:
  - a. Prepare an Environmental Impact Statement (EIS). If the Regional Office believes that the proposal is acceptable based on the EIS, it must then obtain project approval, including approval of noise mitigation measures, from the Assistant Secretary for Community Planning and Development but must also obtain project approval, including approval of noise mitigation measures, from the Assistant Secretary.
  - b. If the Regional Office determines that noise is the only environmental issue and no outdoor noise sensitive activity that is not mitigated to below HUD’s 65-decibel standard will take place on the site, it may request a waiver of the EIS Requirement by the Assistant Secretary

for Community Planning and Development but must also obtain project approval, including approval of noise mitigation measures, from the Assistant Secretary

3. Noise analysis and attenuation of refinance applications is required by 24 CFR Part 51 if the repairs or renovation will convert the building to residential. For rehabilitation projects that do not require noise attenuation, HUD will encourage appropriate noise attenuation measures for inclusion in the property alteration. For all other projects, noise exposure by itself will not result in the rejection of existing properties for insurance, but is a marketability factor that HUD will consider in determining if the amount of any insurance or other assistance that may be given.

I. Explosive/Combustible/Flammable Hazards (24 CFR Part 51 Subpart C).

HUD will not insure a property where structures and residents will be exposed to unacceptable risks posed by proximity to explosive or flammable hazards. This means that for new construction projects, and rehabilitation projects where unit density is increased or where there is a conversion from non-residential to residential or where a vacant building is made habitable, there must be an Acceptable Separation Distance (ASD) away from aboveground storage facilities with explosive, combustible, or flammable material contents and similar industrial facilities. HUD standards regarding proximity to explosive or flammable hazards are found at 24 CFR Part 51 Subpart C. Analysis of sites near or in the vicinity of these types of facilities must be performed by HUD as part of the NEPA environmental assessment in accordance with the HUD guidebook: "Siting Acceptable Separation Distance" (HUD-1060-CPD)". If a plan is agreed upon with HUD before the invitation letter, these hazards may be mitigated during the construction period, if the work can be done on the subject property. For projects to be purchased or refinanced, HUD will substantively evaluate the risks associated with proximity to hazardous facilities.

J. Coastal Barriers (24 CFR 50.4(c)(1)).

Under the Coastal Barriers Resources Act, HUD is prohibited from insuring a project located within designated coastal barriers of the Atlantic Ocean, Gulf of Mexico, or the Great Lakes, known as Coastal Barrier Resource System (CBRS) units and shown on associated Fish and Wildlife Service maps. A project located within a CBRS unit or that includes a facility (such as a water main) leading to a CBRS unit will not be eligible for application processing.

K. Coastal Zone Management (24 CFR 50.4(c)(2)).

Projects located within a state's coastal management zone must be determined to be consistent with the approved state Coastal Zone Management program. In many states, HUD will require a letter from the State Coastal Zone Management Agency confirming consistency with the approved program. Mortgagees should be aware of the extent of coastal management zones in coastal states and contact the field office early when examining a proposal in a coastal zone.

L. Sole Source Aquifers (24 CFR 50.4(d)).

An aquifer is an underground body of water usually kept in place by rock, gravel, or sand. New construction and some rehabilitation projects located within the boundaries of the recharge area of a designated sole source aquifer must be reviewed by EPA for their potential to contaminate the sole source aquifer. HUD offices will identify the local, state or Federal agency with maps of sole source aquifers.

- M. Runway Clear Zone, Runway Protection Zones, Clear Zone, or Accident Potential Zone (24 CFR Part 51 Subpart D).
1. HUD standards regarding the acceptability of property located in Runway Clear Zones (also known as Runway Protection Zones), Clear Zones, and Accident Potential Zones are found at 24 CFR Part 51 Subpart D. An Accident Potential Zone is an area at military airfields that is beyond the Clear Zone.
  2. Construction or major rehabilitation of any property located within a Clear Zone is prohibited. Acquisition, and refinance of projects within Clear Zones are allowed with some restrictions. HUD must determine that projects located in Accident Potential Zones are generally consistent with Department of Defense land use compatibility guidelines for Accident Potential Zones.
  3. HUD, as part of its environmental review for an existing property, shall advise the lender who will advise the mortgagor purchasing the property that the property is in a Runway Clear Zone, Clear Zone, and what the implications of such a location are. The mortgagor purchasing the property must sign a statement acknowledging receipt of this information. HUD may reject applications for existing properties within a Runway Clear Zone or Clear Zone because of the possibility that the property may be acquired at that later date by the airport operator.

N. Environmental Justice (24 CFR 50.4(l)).

HUD will determine whether EO 12898, Federal Actions to Address Environmental Justice in Minority Populations and Low Income Populations, is applicable to the project. This EO requires that federal actions not result in disproportionately high and adverse health or environmental effects on minority or low-income populations. When a project impacts a minority or low-income population, or when siting of a project raises questions of discrimination, HUD will perform the necessary analysis before determining the acceptability of the project. A project that will receive a Low Income Housing Tax Credit and has environmental impacts is a clear example of when environmental justice concerns should be evaluated. HUD will advise the lender of any Environmental Justice concerns including recommendations on their resolution. In most cases the preferred resolution would be to modify the project to eliminate or at least reduce the adverse effects, when feasible.

O. Other Federal or State Laws.

1. Applications for Firm Commitment are subject to provisions of other Federal authorities which seldom require action on the part of HUD, including the Wild and Scenic Rivers Act, Farmland Protection Policy Act, and the Clean Air Act. Certain State regulations also implement air quality

requirements. HUD will advise the lender if any actions under these or other Federal or State authorities are required.

2. HUD may require mitigation of a variety of additional nuisances and hazards on the property which would affect the health and safety of residents and the security of the collateral.
- P. Commonly found or Observed Additional Nuisances and Hazards (applicable to all transaction types except those categorically excluded from all environmental review, as discussed at 9.1A.5 above).
1. Reference for equations and methodology to calculate acceptable separation from high pressure pipelines transferring flammable and combustible liquids and gases is the Final report from ICF International, September 17, 2012, “Research to Support U.S. Department of Housing and Urban Development Regulation 24 CFR Part 51 Subpart C, Siting of HUD-Assisted Projects Near Hazardous Operations Handling Conventional Fuels or Chemicals of an Explosive or Flammable Nature.”
  2. No structure may be located within the easement of any overhead high voltage transmission line. Structures must also be located outside the engineered fall distance of any support structure for high voltage transmission lines, radio antennae, satellite towers, cellular towers, etc. This does not apply to local service electric lines and poles. As such, if a structure is within the distance equal to the height of a support structure, an engineering report that evaluates the support structure’s engineered fall distance is required. The engineered fall distance must be calculated by a registered professional engineer.
  3. HUD requirements for oil or gas wells, sour gas wells and slush pits:
    - a. Operating or planned drilling site: No residential structures may be within 300 feet of the boundary of the drilling site.
    - b. Operating well: No residential structures may be within 75 feet of an operating well, unless the following mitigating measures are taken:
      - i. Controls on nuisances;
      - ii. Controls on noise caused by pumping; and
      - iii. Spill controls to reduce risk of contamination.
    - c. Abandoned wells.
      - i. Confirmation by the State government that the well is safely and permanently abandoned and no residential structures are within 10 feet must be obtained.
      - ii. If there is no confirmation letter, no residential structures may be located within 300 feet of an abandoned well.
    - d. Sour gas (hydrogen sulfide bi-product) wells: Separation distance must be determined by a Petroleum Engineer, with concurrence by State government.

- e. Slush pits (used for drilling mud mixes for well lubrication):
  - i. If on-site, hazards analysis is required to be performed pursuant to Section 9.3 above. Mitigation must include, but not necessarily be limited to, removal of all drilling mud from the site and backfilling with clean compacted material.
  - ii. If offsite, hazards analysis must be performed pursuant to Section 9.3.
  
- 4. If any part of a site is to be developed on filled ground, HUD may require that all grading be properly controlled to prevent differential earth movement, sliding, erosion, and/or other occurrences which might damage dwellings, streets or other improvements. Excessive slopes, soil compatibility, and potential for erosion, are important site planning factors that impact the cost of development and the ultimate success of the project.
  
- 5. Regional Centers or Satellite Offices may adopt additional requirements to address unique local concerns, but, if any local requirement is mandated, the Regional Office must inform the Deputy Assistant Secretary for Multifamily Housing and the HUD Headquarters Housing Environmental Clearance Officer of the requirement and its rationale.
  
- Q. When an environmental assessment level of review is required, HUD will require and analyze information to determine if the project results in any significant impact based on land development, socioeconomic factors, community facilities and services, and natural features. HUD will determine if an environmental impact statement is needed. Specific environmental assessment areas that will be considered include, but are not limited to:
  - a. Conformance with comprehensive plans, zoning compatibility, site safety, energy consumption, and urban impact.
  - b. An assessment of services like educational facilities, commercial facilities, health care and social services.
  - c. Availability of supporting infrastructure such as solid waste, wastewater, storm water, and access to municipal water supply, public safety (Police, Fire, and Emergency Medical Services), open space and recreation, cultural facilities, and transportation.

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## Chapter 10 Management Analysis

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### 10.1 Introduction

- A. Management agents that operate insured multifamily properties play a key role in providing quality housing. While it is the ultimate responsibility of the project owner/mortgagor to select and oversee the management agent of an insured property, the establishment of an effective relationship among HUD, the owner, and the management agent is critical to the success of the property over the life of the mortgage. The management agreement and related documents must be submitted with the Firm Commitment application or can be submitted at the pre-application stage if the management agent has been identified at that stage.
- B. The lender must review whether the proposed management agent demonstrates the qualifications, capability and experience to assure that the property will be managed in a prudent, efficient, and cost-effective manner and in accordance with all HUD requirements. Documentation submitted by the lender in support of the choice of management agent must demonstrate that the agent:
1. Is eligible for approval and is in good standing with HUD. HUD may condition its approval of the management agent upon the resolution of referrals with HUD's Departmental Enforcement Center (DEC) that relate to the management agent, particularly as those referrals may relate to the Project;
  2. Demonstrates effective management experience and acceptable operating procedures commensurate with the type of project;
  3. Has adequate fidelity bond coverage;
  4. Is in compliance with all state and local laws, regulations and requirements; and
  5. Is able to positively communicate and cooperate with legitimate resident associations.

### 10.2 Exhibits Required for Firm Commitment

- A. Exhibits.
1. Evidence of Previous Participation Review. Participants are permitted to submit to HUD their Previous Participation Review submission package for electronic review (currently via Active Partners Performance System ("APPS")) or by paper (currently form HUD-2530) as early as the pre-application processing stage for all principals and affiliates of the management agent.
  2. HUD-9832, Management Entity Profile for the Agent. This form provides detailed information regarding the organization, operation, and experience of the proposed management agent. The management plan should provide a narrative overview and should include any pertinent leasing or management strategies that are not covered in Form HUD-9832.

3. HUD-9839 A, B, or C - Owner's/Management Agent's Certification, as appropriate. In this document, the agent and owner must certify that HUD requirements and contract obligations will be complied with, and that an acceptable Management Agreement will be executed. The agent and owner must certify that no payments have been made to the owner in return for awarding the management contract to the agent, and that no such payments will be made in the future.
4. Proposed Staffing for the Project. Information is required regarding the job-titles, duties, and salaries of all employees of the management agent who will work at the project which will be reviewed to determine if the number, salaries, and duties of the proposed staff is reasonable and adequate for the size and type of the proposed project. If there is a non-customary situation or arrangement, resulting in the need for more or less staff than usual, an explanation of this must be provided.
5. Resident Complaints Resolution Procedure. Provide a description of the procedure used by the agent to resolve resident complaints, as well as examples of how the system has been implemented.
6. Management Agreement, if Applicable. Projects with identity-of-interest management agents or independent fee management agents must execute a Management Agreement. An agreement is recommended, but not required, for owner-managed projects or projects managed by a project administrator.
7. Marketing, Leasing, and (if applicable) Relocation Plan.
  - a. All projects which require absorption of units at economic rents to achieve break-even occupancy must submit a detailed marketing and leasing plan and budget that has been reviewed and confirmed by the proposed management agent. The plan must discuss when marketing efforts will begin, when the leasing office and model units will be opened, how the leasing office will be staffed, and the project's marketing and advertising strategy. The plan must address timing of the construction progress schedule with respect to egress and ingress into the project, landscaping, and access to amenities. These items are in addition to those required by the Affirmative Fair Housing Marketing Plan.
  - b. For substantial rehabilitation projects involving temporary relocation or displacement of existing residents, the plan must address details of timing, funding and management of the relocation process.
  - c. The lender's underwriter, the field office team leader and the Asset Management staff should review the marketing plan. Although not required, the lender may retain a third party property management or leasing consultant to review such plans for large or complex deals or where the proposed property manager is not fully experienced.
8. Affirmative Fair Housing Marketing Plan, Form HUD-935.2A, if applicable. See Section 10.9 for more detail.
9. Additional Information Required by the Field Office. It may be necessary to provide the field office with additional information so that a determination of the acceptability of the proposed management agent can be made.

## 10.3 Lender Review of Management Documents

As part of the Firm Commitment application package, the lender must provide documentation to demonstrate the acceptability of the proposed management agent, with the Management Entity Profile of particular importance. The lender must review the qualifications of the proposed agent to assess its ability to manage the project effectively and in compliance with HUD requirements, and must consider each of the following factors:

### A. Past and Current Management

1. The lender must review the proposed agent's past experience and current performance with respect to the following indicators:
  - a. Experience with projects similar in size and configuration to the subject
  - b. Billing practices
  - c. Controlling operating expenses
  - d. Vacancy rates
  - e. Resident turnover
  - f. Rent collection and accounts receivable
  - g. Physical security
  - h. Physical condition and maintenance
  - i. Financial reporting
  - j. Resident relations
  - k. Resident income certification, record keeping and reporting if an affordable or subsidized project
  - l. Appropriate applicant outreach and affirmative marketing in accordance with a HUD-approved AFHMP
  - m. Tenant selection in accordance with Fair Housing principles
2. If problems are identified with any of these indicators, the lender must assess whether the agent has adequately improved its procedures to prevent the recurrence of such problems or whether management initiatives by the agent and owner are sufficient to correct the problems and their causes.

### B. Ability to Manage Troubled Projects.

If the property has physical, financial or social problems that require special expertise or skills to manage effectively, the lender must determine whether the agent has the necessary skills and expertise and whether the agent's proposed remedies for these problems are appropriate. Agents proposed for these projects should have prior experience successfully addressing similar issues.

### C. Management Qualifications.

The proposed management agent should have at least one senior staff person who drafts the agent's policies and supervises project operations with the following qualifications:

1. A professional designation in housing management from a national organization that provides such accreditation; and
2. A minimum of 5 years of experience in directing and overseeing the management of multifamily projects serving a similar resident clientele.

The lender may accept a proposed agent without the experience requirements listed in this section if the agent is satisfactorily managing other insured or subsidized projects.

### D. Past Performance with Identity-of-Interest Contractors.

If the management agent purchases goods or services from identity-of-interest companies and has previously managed insured projects, the lender must assess the agent's past use of such companies and whether this use resulted in costs to the project that exceed the prices paid in arms-length transactions. The review should especially consider:

1. Goods and services purchased through any "pass-through" arrangements described in item 11(b) of the Management Entity Profile.
2. Evidence that the agent has compared prices and that the use of any identity-of-interest companies or pass-through arrangements has been more advantageous to the project than purchasing through arms-length transactions would have been.
3. Evidence that the management agent followed HUD contracting and hiring guidelines.

### E. The lender can utilize the following additional sources to determine the capability and expertise of the proposed management agent:

1. Management Entity Profile. The lender can use the information listed on the form to solicit opinions from HUD offices that have worked with this agent.
2. Performance Evaluations for the proposed agent and projects which the agent has managed or is currently managing if those projects are under Flexible Subsidy contracts or Workout Agreements.
3. Monthly and Annual Financial Statements of the Project including the Independent Public Auditor (IPA) Internal Controls Questionnaire.
4. Additional documentation that the lender may review includes:
  - a. HUD/mortgagee on-site review reports;
  - b. Correspondence;
  - c. Resident complaint files;
  - d. Previous management reviews;
  - e. Previous REAC inspections/scores, and
  - f. Reviews from federal, state or local government agencies of the management agent's past experience with properties using affordable housing or subsidy programs, if applicable.

## **10.4 HUD Asset Management Review**

Asset Management Firm Commitment reviews will be assigned by the Chief, Account Executive Branch.

The Account Executive will review the various management documents and application exhibits, and advise the HUD Underwriter of their conclusions and recommendations.

The HUD Underwriter will provide the Account Executive with the data necessary for Asset Management to rate the asset once a Firm Commitment is issued.

The HUD Underwriter, Account Executive, and Closing Coordinator will coordinate as needed and appropriate to ensure that Firm Commitment special conditions are met, and timely review of closing documents, turnover of files, and post-closing monitoring.

## **10.5 Review of Previous Participation**

- A. APPS was developed to automate the previous participation review process (currently paper\_Form HUD-2530). If the management agent makes a submission in APPS, select Property submission reason as: "Application for Mortgage Insurance" with role as "Management Agent." Use of the APPS system requires that all participants must register in the Business Partner Registration System (BPRS).
  
- B. While performing a previous participation review, HUD staff will check for all non-compliance issues based on previous participation records and other relevant information in HUD database or from other sources. In addition:
  - 1. Notwithstanding the issuance of the Commitment, previous participation approval of the management agent must be obtained prior to and as a condition of Initial Endorsement.
  - 2. Firm Commitments may only be issued with a condition when the commitment processing is otherwise completed and all principals of the management agent are determined to be acceptable.

## **10.6 Bonding Requirements for Agents**

The lender must determine that the agent has adequate bonding to provide a basic level of protection for the multifamily project assets.

- A. The management agent must certify in the Management Certification that it carries fidelity bond or employee dishonesty coverage for:

1. All principals of the management entity; and
  2. All persons who participate directly or indirectly in the management and maintenance of the project and its assets, accounts, and records.
- B. The fidelity bond or coverage must name the mortgagee and HUD as additional loss payees.
- C. Coverage may be through one or more bonds, and one bond may cover more than one project, including projects whose mortgages are not insured or held by HUD. The agent's principals and supervisory and front-line staff may be covered under the same bond.
- D. Each project must be bonded for at least the value of two months' gross potential income for the project. If a bond covers more than one project, this minimum must be computed using the project with the highest gross potential income.

## 10.7 Management Agreement Requirements

- A. Applicability. Projects with identity-of-interest agents or independent fee agents must execute a Management Agreement. An Agreement is recommended, but not required, for owner-managed projects or projects managed by a project administrator.
- B. Required contents. The owner and agent may negotiate their own form of agreement provided that it contains language which meets the following requirements:
1. Scope of services. All management agreements must describe the services the agent is responsible for performing and for which the management fee will be paid.
  2. Required clauses. All agreements must provide that:
    - a. Management fees will be computed and paid according to HUD requirements.
    - b. HUD may require the owner to terminate the agreement:
      - 1) Immediately without penalty if an event of default occurs under the Security Instrument, Note or Regulatory Agreement; or
      - 2) Upon 30 days written notice, for failure to comply with the provisions of the Management Certification or for other good cause; or
      - 3) When HUD takes over the property as Mortgagee in Possession.

**NOTE:** The management agreement must always give the owner the ability to terminate the contract for cause, with no more than a 30 day notice period.
    - c. If HUD terminates the agreement pursuant to its authority under the loan documents (HUD-92466M, Regulatory Agreement provision 21), the owner will promptly make arrangements for obtaining an alternative management agent that is satisfactory to HUD.
    - d. HUD's rights and requirements will prevail in the event of any conflicts with the terms of the management agreement.

- e. The management agent must turn over to the owner all of the project's cash, accounts, deposits, investments, and records immediately, but in no event no longer than 30 days after the date the management agreement is terminated.
3. Prohibited "hold harmless" clause. Management Agreements cannot exempt the agent from liability for damages, injuries and losses. This includes all "hold harmless" provisions, such as parties holding each other harmless except in the case of willful misconduct/ gross negligence. Allowing a management agent to be held harmless for all breaches of the standard of care less than willful misconduct/ gross negligent is against HUD policy (such an exemption would allow a management agent to be held harmless for negligence)."
- C. Length/term of the Agreement. The length/term of the Management Agreement will be negotiated between the owner and the management agent. However, HUD will require a minimum one-year term. HUD may also impose a maximum term on the Management Agreement if the agent was approved by HUD on a conditional basis.
1. The Agreement may provide for a fixed term or an open-ended term (e.g., automatically renewable or "to remain in effect until cancelled by HUD, the owner, or the agent").
  2. If the length /term of the Agreement changes before initial endorsement, the owner/agent must submit a new Management Certification.
- D. Management Fee: The Agreement must include all specifics of the management agent compensation and how the management fee will be calculated, including any incentive management fees to be paid from surplus cash. HUD will review the fee for adequacy and reasonableness for a project of the size and complexity as what is proposed. The management fee must be equivalent to, and be no less than, a market rate fee that would be charged by a replacement, third party management agent, if the replacement agent were to assume responsibility for management of the property.

## **10.8 Approval of Proposed Management Agent**

- A. The lender will recommend approval to the Hub Satellite office of the proposed agent if the agent has demonstrated capacity to effectively manage the property within HUD requirements, the management agent has shown adequate fidelity bond coverage and the Previous Participation Certification is approved. In some instances, the lender may find it necessary to recommend conditional approval if there are areas of the agent's procedures that are considered weak or that need to be changed. All conditional approvals will be discussed with the proposed agent and any agreements/conditions that are imposed will be shown both in the letter approving the agent, and in the Firm Commitment.
- B. The lender must provide a report regarding its review and recommendation which includes the following information:
1. Name of the proposed management agent.
  2. Composition of the proposed management agent.
  3. Narrative of the agent's experience and capacity to operate the subject property, with particular emphasis on its past experience and capacity to manage affordable or subsidized properties, if applicable.

4. Demonstration that adequate fidelity bond coverage is in effect and that the proposed management agreement meets HUD's requirements.
  5. A recommendation to approve the proposed management agent.
- C. The Hub/Satellite office may disapprove a proposed management agent based on the decision of the Review Committee to deny or withhold approval for the proposed agent's participation. The Committee may base its disapproval on the lack of the management agent's capacity to effectively manage the project within HUD requirements and to adequately meet the requirements of this Chapter. To proceed with a Firm Commitment review, the owner must then propose an alternative management agent (and supply all required documentation). The owner may appeal the decision of the Previous Participation Committee under 24 CFR, Part 200.241.
- D. HUD will review the lender's report and the management entity profile and make the final determination to accept or reject the proposed management agent.

## **10.9 Affirmative Fair Housing Marketing**

The Affirmative Fair Housing Marketing Requirements (24 CFR 200.600, Subpart M) apply to all insured new construction and substantial rehabilitation projects of 5 or more units. Each applicant for insurance must submit an Affirmative Fair Housing Marketing Plan (AFHMP) or Form HUD-935.2A. The plan must describe an affirmative program to attract residents regardless of race, color, religion, sex, disability, familial status, sexual orientation or national origin to the housing for initial rental. The plan must show use of a marketing area with a diverse population and targeted outreach to demographic groups in the diverse area that are least likely to apply for the housing. The affirmative advertising program shall use majority and minority media and organizations and target those groups within the market area that would not ordinarily apply without concerted outreach. . The plan should include information on the applicant's nondiscriminatory hiring policy, its training program on nondiscrimination for its rental staff, and the display of the Department's Equal Housing Opportunity logo type and slogan. HUD must review and approve the Plan prior to the issuance of the Firm Commitment. The HUD approved AFHMP must be closely followed by the owner and management agent and must be regularly updated in accordance with HUD requirements.

Applications under Section 223(f), while covered by the nondiscrimination provisions of the Fair Housing Act and Executive Order 11063, are exempt from the submission of a written plan. However, a Section 223(f) applicant is required to maintain records of its affirmative marketing efforts.

## **10.10 Management Agent Responsibility for Escrow Administration**

Management Agents must cooperate with the lender and with the Hub/Satellite office staff in administration of the Initial Operating Deficit (IOD) escrow, including any disbursements permitted and

the release of any escrow balance remaining. The terms and procedures for release of the IOD are addressed in Section 12.15.D.2.

Management Agents must cooperate with the lender and with the Hub/Satellite office staff in administration of the Reserve for Replacements account (per the reserve schedule and deposit requirements included in the Firm Commitment) and in the requirement to obtain a new Project Capital Needs Assessment (PCNA) every 10 years during the loan term. See Appendix 5 for more details on PCNAs.

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# Chapter 11

## Lender Underwriting, HUD Review and Closing Matters

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### 11.1 General

The MAP program delegates due diligence and underwriting responsibility to MAP approved Underwriters and lenders. The MAP approved Underwriter is expected to be completely familiar with the contents of the MAP Guide, have demonstrated experience and mastery of commercial lending practices and real estate finance, and have a working knowledge of HUD regulatory and statutory authority.

HUD retains commitment authority and responsibility for final determination of acceptable risk to the insurance fund, as well as certain technical and compliance responsibilities. This in no way relieves the MAP Lender from responsibility for their underwriting and programmatic compliance.

The basic function of a MAP approved Underwriter is to objectively evaluate the following factors in making a credit approval recommendation:

- Character, creditworthiness, competence, and capacity of the borrower and development team members;
- Cash flow sufficient to service the proposed loan;
- Collateral quality, including valuation, physical condition, environmental factors and location;
- Capital structure, including all proposed indebtedness and equity;
- Cash available to close, given the total mortgageable and non-mortgageable costs of the transaction; and
- Compliance with HUD program and processing requirements.

The Underwriter must identify all material risks and weaknesses, with appropriate mitigants including quantitative analysis and stress testing to identify the impact of “worst case” scenarios. If a transaction recommended by a lender is properly underwritten and processed, and is complete and technically compliant, HUD’s role is to review the application and the lender can assume a timely determination.

If the application fails to identify material underwriting risks and mitigants, or has material processing or compliance deficiencies, HUD has the option to reject the application, re-underwrite it and approve with conditions, or return the application to the lender for modifications to address deficiencies.

The responsibilities of MAP lender and HUD underwriters are addressed in Chapter 4 (Processing) and in this chapter.

## 11.2 Lender Underwriting

- A. The lender is responsible for assigning a MAP approved Underwriter for the Pre-application or Firm Commitment. The MAP approved Underwriter is responsible for the selection and performance of the third party professionals (both the firms and individuals). The Construction Loan Administrator must be approved prior to the Firm Commitment stage if the closing and servicing lender has been identified, or as soon as identified.

The lender's MAP Approved Underwriter is responsible for oversight and performance of the following tasks:

1. Data collection;
  - a. Due diligence, including selection and management of their third party consultants. The MAP Lender is responsible for underwriting the loan. This responsibility necessarily requires the lender's oversight, acceptance and recommendation to HUD for approval of the conclusions and recommendations of the third party reports, except as modified, explained, and justified in their underwriting
  - b. Loan Processing;
  - c. Mortgage Credit review;
  - d. Underwriting;
  - e. Obtaining internal loan approval (from the lender's loan committee or other process);
  - f. Submission of the loan application to the appropriate Regional Center or Satellite Office and payment of the application fee;
  - g. Responding to HUD deficiency letters and requests for information;
  - h. Coordinating with the lender and their counsel, and follow-up to get the loan to closing;
  - i. Coordination with construction loan administration, cost certification, and servicing.
- B. Pre-application. The lender's underwriter must determine that the submission meets the requirements of this Guide and represents an acceptable risk to the insurance fund. The pre-application submission to the field office must include a Standardized Underwriter Narrative, and together with any additional information and all narrative attachments, which provides:
  1. A summary of the relevant data and quantitative analysis.

2. Strengths, weaknesses, risks and mitigants.
3. A summary of programmatic eligibility and technical factors considered.
4. A description of the proposed project and the surrounding market conditions, including demand, extent of competition, vacancy rates, market absorption, details about features of the proposal (e.g., zoning, unusual site conditions, environmental) which may present potential problems, and any other information that would be useful to analyze the proposal.
5. A description of the individual or entity in control of the borrower (plus general contractor and management agent, if known), their qualifications, the identification of principals and a preliminary mortgage credit and creditworthiness review.
6. Explanations for any differences between the underwriting conclusions and the third party due diligence.
7. A list of proposed in-house and third party reviewers of the application and their qualifications.

Further details on the required content of the Standardized Underwriter's Narrative and the materials to be included in the pre-application can be found in this Guide and appendices.

C. Firm Commitment Application: The lender's underwriter must review the in-house and third party reports to ensure the processing of the loan is in accordance with the requirements of this Guide and determine that the loan recommendation represents an acceptable risk and is financially sound. The underwriter must document any changes made to the technical reports and must submit an updated, signed Standardized Underwriter's Narrative describing all relevant aspects of the mortgage transaction including a full discussion of the following:

1. Characteristics of the proposed mortgage loan that make it financially sound or an acceptable risk, with the reasons why the lender recommends the loan.
2. All significant risk factors and risk mitigants.
3. Changes in the project from the pre-application stage including changes in sponsorship, proposed development team and lender reviewers.
4. Evaluation of the mortgage credit and financial capacity of the principals of the borrower and its ability to repay the loan.
5. Evaluation of the financial and technical capacity of the general contractor to build/rehabilitate the project.
6. Property financial analysis (both actual operating history and projected trends).
7. Property physical description.
8. History of borrower's involvement including their equity investment in the property, and if applicable, any previous engagements to obtain FHA financing for the property.
9. Analysis of market, rents, expenses and estimated rent-up and operating deficit.
10. Adequacy of the proposed Reserve for Replacement.
11. Documentation of any changes the underwriter made to the appraisal/technical reports with justification.

12. Requests for any waivers of Guide requirements with supporting documentation and justification summary.
13. Certifications from the individual reviewers (see Section 11.2.H).

Further details on the required content of the Standardized Underwriter's Narrative and the materials to be included in the Firm Commitment application can be found in this Guide and appendices.

- D. The MAP Underwriter should perform the site visit for new construction properties and for existing properties an on-site lease audit and physical inspection representing a sample of each unit type. Alternatively, an analyst, underwriter trainee, or different MAP approved underwriter acting under the direction of the underwriter (i.e., one that does not report to the originator) may perform the site visit and physical inspection of the units. The underwriter or trainee who conducts the inspection must be identified in the narrative. Typically, the leases that are audited will be the same as the units that are inspected, as follows:
  1. For projects 50 units or less: Inspect at least 1 of each unit type, to include a representative sample of 10% of the units.
  2. For projects between 51 and 250 units: Inspect at least 1 of each unit type, to include a representative sample of 10 units plus 5% of the total number of units greater than 50.
  3. For projects greater than 250 units: Inspect at least 1 of each unit type, to include a representative sample of 15 units, plus 2% of the total number of units greater than 250, for a maximum of 50 units.
  4. The terms of the leases must be compared to the rent roll, verifying the unit number, resident name, lease commencement date, expiration date, concessions, if any, and monthly rent, and must confirm that this data is consistent with the assumptions used in the underwriting analysis.
  5. Any inconsistencies or conflicts between the leases, rent roll and the underwritten revenue assumptions must be fully investigated and explained. The scope and results of the lease audit review must be discussed in the Underwriter's Narrative. The underwriter should retain a copy of the individual leases reviewed in their working papers, which may be subject to audit but should not be included in the Firm Commitment application submission.
- E. The underwriter is responsible for the review and reconciliation of the third party reports and the results of the mortgage credit review and other due diligence.
- F. Lender Due Diligence Certification: With each Firm Commitment package, the lender must submit a letter signed by the MAP approved underwriter which certifies that:
  1. The lender has reviewed all in-house and third party forms/reports/reviews;
  2. The preparer of the forms/reports/reviews is qualified as required by this Guide and has all required insurance coverage(s);
  3. The forms/reports/reviews were prepared in the manner required by the Guide are complete and accurate;

4. The identity of staff and contractors who contributed to the underwriting presentation and their role; and
5. The proposed loan represents an acceptable risk to the Department and is financially sound, based upon the lender's review and analysis, and that the application complies with all HUD statutory, regulatory, guidebook and administrative requirements.

The letter must include the following certification and language:

I am employed full time by the MAP Lender and have no other side deals, agreements, or financial considerations in connection with this transaction.

- G. Third party report Certifications. The following Certification must be included in the lenders third party reports:

I understand that my (appraisal, market study or architectural, cost, environmental, or other specialized report) will be used by \_\_\_\_\_ (name of MAP Lender) to document to the U.S. Department of Housing and Urban Development that the MAP Lender's application for FHA multifamily mortgage insurance was prepared and reviewed in accordance with HUD requirements. I certify that my review was in accordance with the HUD requirements applicable on the date of my review and that I have no financial interest or family relationship with the officers, directors, stockholders, members or partners of the lender or affiliated entities, Borrower or affiliated entities, the general contractor, any subcontractors, the buyer or seller of the proposed property or engage in any business that might present a conflict of interest.

- H. Both the underwriter and third party certifications must contain the following warning language:  
\_\_\_\_\_  
Signature.

I hereby certify under penalty of perjury that all of the information I have provided on this form and in any accompanying documentation is true and accurate. I acknowledge that if I knowingly have made any false, fictitious, or fraudulent statement, representation, or certification on this form or on any accompanying documents, I may be subject to criminal, civil, and/or administrative sanctions, including fines, penalties, and/or imprisonment under applicable federal law, including but not limited to 12 U.S.C. § 1833a; 18 U.S.C. §§1001, 1006, 1010, 1012, and 1014; 12 U.S.C. §1708 and 1735f-14; and 31 U.S.C. §§3729 and 3802

- I. HUD Forms Submission. The lender must submit a Standardized Underwriting Narrative, "wheelbarrow" data submission and a HUD-92013. The HUD-92264 and HUD-92264-A forms are still required at this time; no signature by the lender or their third parties is required. The lender must certify that all parties preparing forms, reports or reviews are qualified as required by the Guide.

### **11.3 HUD Regional Center or Satellite Office Underwriting Review**

- A. Under the direction of the MF Regional Center Director or other appropriate managers, the HUD underwriter is responsible for coordinating with technical support and other HUD staff, and the oversight and performance of the following tasks:
- i. Conduct of Concept meetings and follow-up communication;
  - ii. Review of proposed MAP Lender and Underwriters and reporting to Asset Management and Counterparty Oversight Division is any concerns;
  - iii. Working with the Workload Distribution Lead for the Regional Center and/or Satellite Office and other appropriate officials in managing workload assignments for new applications;
  - iv. Screening applications for completeness, and fiscal controls for new application submissions;
  - v. Conducting an “Early Warning System” screening to determine what level of underwriter and technical specialist review is required given the complexity and risk factors associated with the transaction, and specific risk issues in the transaction;
  - vi. After screening or during the underwriting and technical review, the Regional Center or Satellite Office will advise the lender of deficiencies in the application and the lender will have 5 business days to correct the defects or deficiencies. If the defects/deficiencies cannot be corrected within the 5 business days, or such other time frame as the Regional Center Director determines as appropriate, HUD will reject the application.
  - vii. Acknowledging receipt of the application, management of the queue and estimating processing target dates;
  - viii. Advising the lender if there are deficiencies or additional information is needed;
  - ix. Performing technical reviews based on lender underwriting and third party reports, or arranging for technical specialist reviews for higher risk or complex transactions or functions that need specific technical analysis given the features of a particular transaction;
  - x. Recommending transactions for loan approval (or rejection) decisions;
  - xi. Preparing and issuing Pre-application Invitation letters and Firm Commitments;
  - xii. Coordinating the closing process with OGC, the lender, and borrower’s team;
  - xiii. Coordinating with Asset Management in turnover of files, briefing about conditions of the Firm Commitment, and providing information necessary for Asset Management’s risk rating of the transaction.
  - xiv. Coordinating with Asset Management and/or HUD’s Departmental Enforcement Center (DEC) to ensure that any open DEC referrals with respect to the borrower or the proposed managing agent are resolved.
- B. Pre-application and Firm Commitment Processing.

The HUD underwriter will conduct, or arrange for the Pre-application or Firm Commitment review, including any required technical specialist reviews. The HUD underwriter will coordinate the technical reviews, resolve any inconsistencies and make a recommendation as to whether an

application should be approved, modified or rejected. They must document and justify any recommendation to approve a loan or to require conditions with which one or more technical reviewers non-concurs.

If a HUD technical review does not concur with the conclusions approved by the Regional Center or Satellite Office Director, they may document their non-concurrence separately in the file. The HUD underwriter should address the non-concurrence and document how the issues were addressed in the loan approval decision.

Upon completion of the technical reviews and the environmental assessment, the HUD Underwriter will prepare a memorandum to the Regional Center or Satellite Office Director summarizing the individual reviews of the specialists, any proposed waivers of Guide requirements and the Team Leader's overall recommendation.

### C. Underwriting Recommendation.

The memorandum recommending loan approval will be in the standard loan committee report or alternative format, and specifically address:

1. The adequacy of the initial operating deficit for any new construction or substantial rehabilitation loans;
2. The adequacy of the working capital escrow and construction contingency for any new construction or substantial rehabilitation loans;
3. The adequacy of the initial deposit and ongoing payments to the reserve for replacement;
4. A description of any non-critical repairs to be performed after closing for Section 223(f) loans;
5. In a tax credit transaction, the schedule of the equity contribution at closing and remainder during various stages of the construction period;
6. The architectural drawings and specifications; and
7. Any environmental conditions or other concerns.

Back-up documentation necessary to prepare and issue the Firm Commitment should be attached or available, including Previous Participation Certification from APPS, the technical staff reviews, the lender narrative summary, the lender's technical reviews, Forms HUD-92264 and HUD-92264-A signed by the HUD reviewers and Team Leader. Where the HUD underwriter has rejected a conclusion by a technical reviewer, or has modified any technical recommendation by the lender or HUD reviewer, documentation and justification must be included in the memorandum.

HUD's review appraisers have the option to modify appraisal conclusions internally or to return the application to the lender for revision of the appraisal. Should the HUD review appraiser choose to modify the appraised value, rent or expense conclusions internally, as per USPAP Standard 3, this opinion becomes its own appraisal whether it concurs with the opinion of value in the work under review or differs from the opinion of value.

#### D. Firm Commitment Issuance, Amendments, Reissuance, and Extensions.

1. Upon issuance of a Firm Commitment, the HUD Underwriter will provide such support as needed and requested to the closing coordinator to prepare for closing, and provide files, data, and information as needed by the Account Executive to facilitate Asset Management's rating and servicing of the loan.

2. Firm Commitments will be issued for a term of 60 calendar days. The lender has the option of requesting an extension of the Commitment to prepare for the Initial Endorsement submission. The Regional Center Director (or their designee in accordance with delegated authority) may grant one or more extensions for up to a total of 120 calendar days from the original expiration date. Further extensions must be approved by the Director of Multifamily Production in HUD Headquarters.

When the Regional Center Director determines that extenuating circumstances justify a limited extension of an outstanding Firm Commitment, the lender must certify and Regional Center Director must concur that the documentation provided by the lender demonstrates that granting the extension will not likely change the underwriting data and assumptions on which the Firm Commitment was issued or undermine the feasibility of the project. Such factors include but are not limited to a change in the borrower's or development team's configuration or financial capacity, market, inflation or other factors impacting cost. A change in the interest rate or other terms or conditions of the Firm Commitment may require reprocessing and amendment of the Firm Commitment.

If a Firm Commitment has been extended beyond 120 calendar days from its original date, the lender must provide updated appraisal/market study, cost and mortgage credit, or other information as required by the Regional Center or Satellite Office for review prior to loan closing.

3. Only the Regional Director, Regional Operations Officer, Production Division Director, or other officials formally designated to act in these capacities are authorized to sign Firm Commitments or endorse Insured Mortgage Notes.
4. The Department has limited flexibility to permit the resubmission of rejected applications. In accordance with the procedures contained in HUD Handbook 4410.1 Rev-2, Project Fiscal Procedures will apply.
5. Amended Commitments. An amended commitment bears the same date as the original commitment, followed by the date of the amendment, although the applicable regulations are those in effect on the original commitment issuance date. Most underwriting changes, such as changes in mortgage amount and/or interest rate, will be incorporated in letter amendments to the commitment.

6. Special Conditions. Special Conditions are part of the Firm Commitment. Changes to the specific terms of such conditions, or allowing closings to proceed when conditions are not yet met, must be documented with a letter amendment to the Firm Commitment
- E. Reissued Commitments. A reissued commitment will have its own date which will control what regulations apply and how long the commitment will remain in effect, and will substitute for the originally issued commitment. A lender which accepts a reissued commitment will no longer have rights granted under the original, or a previously amended, commitment. A re-issued commitment is required for:
1. Requests for reconsideration of an expired or terminated commitment;
  2. Changes in project location;
  3. Major changes in plans and specifications; and
  4. Reprocessing to reflect changes in the MIP.
- F. Waivers.
1. Statutory requirements shall not be waived under any circumstance. Regulations may only be waived by an Assistant Secretary (usually the FHA Commissioner for MAP loan issues other than environmental regulatory waivers) If there are questions about whether a given requirement is statutory or regulatory, please consult with the HUD Office of General Counsel.
  2. The Regional Center Director may waive requirements of this Guide that are not statutory or regulatory except for the following matters which must be approved in HQ:
    - a. Debt coverage ratios for all programs;
    - b. Loan to value ratios for Section 223(f) loans;
    - c. Loan to cost ratios for the 221(d) and 220 programs;
    - d. Traditional Application Processing for MAP eligible transactions;
    - e. Substantive modifications to the Ground Lease addendum form (HUD-92070M);
    - f. The requirement for a Single Asset Borrower Entity (see 24 CFR 200.5);
    - g. The prohibition on a lender advancing fees for payment of discounts on behalf of the Borrower;
    - h. Payment of broker or referral fees to any party with an identity of interest with the borrower or its affiliates;
    - i. Extensions of Firm Commitments beyond 180 days of issuance (original term of 60 days plus up to a 120 day extension);
    - j. Approval of applications in which the Regional Environmental Clearance Officer non-concurs with approval of an FHA mortgage insurance application; and

- k. Approval of properties subject to floodway and coastal high-hazard area prohibitions with improvements in a floodplain considered incidental.
3. The Regional Center Director will submit to the Director of the Office of Multifamily Housing Production all waiver requests requiring HQ approval as early as possible. Requests for regulatory waivers will take longer to process since they require review and concurrence from the Office of General Counsel and the Deputy Assistant Secretary for Multifamily Housing, as well as the approval of the FHA Commissioner. HQ will not consider waiver requests submitted directly by MAP Lenders.
4. Any waiver granted in connection with the proposed transaction must be documented in the field office docket and HQ docket, along with the lender's request and field office request. Waivers granted by the Regional Center must be submitted, along with supporting documentation, to the Office of Multifamily Housing Production to determine if changes to this Guide or the regulations are necessary.

## **11.4 Program Closing Provisions**

The FHA Multifamily Program Closing Guide addresses various program closing provisions and procedures that the lender must be aware of to prepare for initial closing, final closing and initial/final closing events. The HUD underwriter's responsibilities include:

- A. Ensuring all Special Conditions to the Commitment have been individually addressed and satisfied, including the resolution of any open DEC referrals, prior to or in tandem with closing;
- B. Reprocessing and amending Firm Commitments as necessary and appropriate;
- C. Extending or Re-issuing Firm Commitments; and
- D. Coordinating with Asset Management staff to ensure the orderly transition from Production to Servicing.
- E. Coordinating the closing schedule with OGC, the lender, and borrower;

## **11.5 Loan Fees**

- A. Loan Fees. Lenders may charge loan origination and placement fees, both of which are mortgageable, and the combination of which cannot exceed 3.5% of the mortgage amount (or 5.5% for tax-exempt bond financing) for Section 223(f) refinancing transactions and new construction or substantial rehabilitation transactions. The maximum fees for Section 223(a)(7) loans is 2% for loans greater than \$2 million, and up to \$40,000 for loan amounts less than \$2 million. In addition to loan origination and placement fees, lenders may realize trade profit (also known as marketing gain) on the sale of Ginnie Mae or other mortgage backed securities.

Mortgagee Letter 2011-5 revised the loan fee reporting requirements for multifamily lenders. Lenders

are now required to report loan fees earned that exceed five percent (5%) of the insured loan amount on each FHA-insured loan over \$2,000,000 endorsed during the lender's fiscal year period covered in its audited financial statements. Loan fees include: (a) origination and placement fees as permitted by this Guide, plus (b) trade profit, trade premium or marketing gain earned on the sale of the Ginnie Mae security at a value above par, even if the security sale is delayed until after endorsement, minus (c) loan fees applied by the lender to its legal expenses incurred in connection with loan closing. This reporting is confidential and is not subject to release under the Freedom of Information Act, but will be examined by HUD in evaluating counterparty risk as part of the lender monitoring responsibility.

The loan fees on a particular transaction that exceed 5% must be reported by both the originating lender and closing lender when the loan is assigned for closing and fees are split between the two entities. Trade profit fees used to pay prepayment penalties on behalf of a borrower in a Section 223(a)(7) transaction are not net out of the loan fees in calculating whether or not the loan fees exceeded 5%.

B. Loan fees are earned are as follows:

1. Construction loan fees are earned at initial closing, except to the extent that the loan documents defer a portion to a later date. Construction loan extension fees are not earned until the time such extensions are granted.
2. Permanent loan fees and permanent loan extension fees, to the extent a separate permanent loan is anticipated, are earned at final closing.
3. Construction/Permanent loan fees (for construction loans anticipated to convert to permanent loans) are earned at initial closing, except to the extent that the loan documents defer a portion to a later date.

C. Deferred Fee Collection. Section 8.15.D.4 sets forth provisions for the deferred collection of fees in connection with tax-exempt bond financing.

D. Broker's Fees.

1. Fees to mortgage brokers are allowed so long as they are disclosed in the Underwriting Narrative and form HUD-92434M (or HUD-92455M, as appropriate), there is no identity of interest between the mortgage broker or its affiliates, or the lender and its affiliates, and the borrower or its affiliates, and the broker is actively engaged in the business of mortgage loan origination.

Referral fees to other parties, such as consultants, management agents, or entities or individuals with any identity of interest with the borrower or its affiliates are prohibited.

2. Lender or affiliates of lenders may not pay anything of value directly or indirectly to any person or entity in connection with an insured transaction if the person or entity has received any other compensation from borrower, seller, builder or any other person for services related to the transaction, or related to the purchase or sale of the mortgaged property, except as approved by the Director of Multifamily Production in HUD Headquarters. See 24 CFR 202.5(l).

## **11.6 Title Matters**

- A. As noted in the Application Checklist, a preliminary or pro forma title search should be reviewed as part of the Firm Commitment processing. It is used to validate existing indebtedness, ensure correct legal description of the parcel(s) to be mortgaged, and the adequacy of title with respect to matters such as liens, easements, restrictions and other exceptions. Please see the FHA Multifamily Program Closing Guide for additional requirements related to title and survey matters.
- B. Air Rights and Other Shared Interest Projects.
1. A three dimensional air rights map for air rights projects is required. The existence of adequate vertical ways to the ground for required services, e.g., utility and fire suppression lines, chimneys, trash chutes, elevators and emergency exit stairs must be verified. In addition, there must be an acceptable discharge to a public way from all building egresses, including emergency exits, and services, e.g., trash removal.
  2. Maintenance, joint use, easement and other agreements may be required. In cases where common facilities exist between the insured parcel and an adjacent parcel, borrower must provide for recordation of an agreement for the common use land and facilities, e.g., common drives, common lobbies, elevators, walkways, utility roads, parking structures, recreation facilities, storm water management facilities (retention ponds detention ponds, swales and culverts) or other air rights project common facilities. The agreement must grant rights to the HUD project site and its residents to use the common facilities. If the HUD project is subject to property/homeowner association documents such as with a cooperative, these documents may provide for maintenance, access and cost sharing, which must be determined acceptable to HUD prior to or as a condition of the Firm Commitment.
  3. If the air rights parcel in on a leasehold, it will need to include the Ground Lease addendum form (HUD-92070M) with minimal modifications to reflect an air rights lease.
  4. The Regional Center or Satellite Office Director must:
    - a. Assure that the integrity and maintenance of air rights platform foundations and other structural members are defined as the air rights provider's responsibility.
    - b. Verify that shared maintenance/operating costs are equitable and that enforcement rights protect the project interests.
    - c. Require easements, cross easements or other documents to provide the HUD project and its residents the right to use the common facilities.

## **11.7 Borrower Entity's Organizational Documents**

- A. Borrower Entity's Organizational Documents
1. General. Draft (or final) organizational documents should be reviewed as part of the creditworthiness analysis during Firm Commitment underwriting. Organizational documents for the borrower entity are required to be submitted at closing. The specific documents required for each type of borrower entity are set forth in the FHA Multifamily Program Closing Guide. These requirements apply to all types of closings including initial, initial/final, and final endorsements.

For multi-tier entities, mortgagor entities will also be required to submit organizational documents for the tier at which Multifamily Regional Center staff has determined ultimate control over the day-to-day operations of the project resides.

2. Terms. The documents must include the required language found in the FHA Multifamily Program Closing Guide, and at a minimum must expressly state:
  - a. That the duration of the borrower entity is at least as long as the term of the FHA-insured mortgage.
  - b. That the terms of the HUD Regulatory Agreement take precedence in the event of any conflict with the terms of the organizational documents. Note the document should not include language which is in direct conflict with the terms of the Regulatory Agreement or the HUD required language from the Closing Guide.
  - c. That the borrower entity has authority to enter into the transaction and to comply with the requirements of the insurance program.
  - d. That unless approved otherwise by HUD, the borrower entity is a single purpose-single asset entity.

## **11.8 Note**

- A. Term. The term must be the same as specified in the Firm Commitment, which must be within the maximum terms allowed by the program and not less than 10 years.
  1. Generally, for most new construction or substantial rehabilitation rental projects, the term, calculated from the date of completion of construction, may not exceed the lesser of 40 years or 75% of the project's remaining economic life.
  2. For existing projects (insured under Section 207 pursuant to Section 223(f)), the term must be not less than 10 years, and may not exceed the lesser of:
    - a. 35 years, or
    - b. 75% of the estimated remaining economic life of the physical improvements.
  3. For 223(a) (7) projects, the term of the mortgage is limited to 12 years beyond the remaining term of the existing mortgage (excluding any previous Section 223(a)(7) loan) so long as the PCNA and underwriting determine that the loan term is no more than 75% of the remaining useful life of the property.
- B. Prepayment Provisions. Generally, prepayment lockout and/or penalty structures that are commercially reasonable and consistent with industry practice, that expire after 10 years and are no more than 10% during any of the first 10 years, and no more than 1% thereafter are acceptable, so long as the interest rate is commercially reasonable at the time of the rate lock.

The following additional conditions and terms apply:

1. Market rate properties.
  - a. Prepayment must be permitted in whole or in part so long as 30 days advance written notice is given to lender of intent to prepay, except for Section 223(f) loans (subject to statutory five

year prepayment lockout), which must meet certain conditions and receive HUD approval if the property will be converted to a use other than rental housing, in order to prepay within the five year prepayment lockout.

- b. Prepayments must be permitted for up to 15% of the original principal amount in any one calendar year without a prepayment charge. Prepayments exceeding 15% may be subject to a reasonable charge agreed to by borrower and lender and included in the Mortgage.
- c. Notwithstanding the borrower's right to prepay, a HUD 9807 must be processed in order for HUD to release the recorded Regulatory Agreement.

2. Affordable or subsidized properties.

- a. FHA insured projects which are, or formerly were, affordable or subsidized and are subject to a Use Agreement, Regulatory Agreement, or similar restrictive covenants require prior written consent of HUD to prepay the mortgage debt.
- b. HUD may approve partial prepayments to reduce succeeding monthly payments over the remaining portion of the original mortgage term, or may also approve partial prepayments made after 30 days written notice. Prepayments exceeding 15% of the original principal amount may be subject to a reasonable charge on such excess as agreed to by borrower and lender and included in the Mortgage.

3. Prepayment of bond-financed or Ginnie Mae securitized mortgages. Where the mortgage is given to secure Ginnie Mae mortgage-backed securities or a loan made by a lender that has obtained the funds for the loan by the issuance and sale of bonds or bond anticipation notes, or both, the mortgage may contain a prepayment restriction and prepayment penalty charge acceptable to the Commissioner as to term, amount, and conditions.

C. Conditions for Including Lockouts and/or Penalties. Compliance with the following conditions is required when prepayment lockouts and/or penalties are permitted.

1. Lender's Certificate and Request for Endorsement. The Lender's Certificate, Form HUD-92434M (section 24(a)) and the Request for Endorsement, Form HUD-92455M (section 25(a)), requires the lender to certify that in the event of a default during the term of the prepayment lockout and/or penalty (i.e., prior to the date on which prepayment may be made with a penalty of one percent or less), it will comply with Program Obligations. The Lender, in order to comply, must:
  - a. Request a 3-month extension of the deadline prescribed by 24 C.F.R. Section 207.258(a)(2) for filing a notice of its intention to file an insurance claim and its election to assign the mortgage;
  - b. Assist the Borrower to arrange refinancing to cure the default and avert an insurance claim if HUD grants the requested (or shorter) extension of the notice filing deadline;
  - c. Report to HUD at least monthly on any progress in arranging a refinancing;
  - d. Otherwise cooperate with HUD in taking reasonable steps to avoid an insurance claim;
  - e. Require any successors or assigns to certify in writing that they agree to be bound by these conditions for the remainder of the term of the prepayment lockout and/or penalty period; and
  - f. Notify HUD of the delinquency where a payment is not received by the 16th day of the month in which it is due.

- D. Late Charge Provisions. Lender may collect a late charge for the cost of handling delinquent payments, subject to the following:
1. Charges must not exceed two cents per dollar of unpaid principal and interest that is more than 10 days in arrears.
  2. Late charges must be separately charged to and collected from borrower and cannot be deducted from any total monthly mortgage payment, or collected from any reserve escrow, residual receipts funds, or from any interest accruals thereto.
- E. Where obligations pursuant to tax-exempt bond financing or Ginnie Mae involvement do not impose restrictions independent of the lender's restrictions, HUD may consider exercising an override of prepayment lockout and/or premium provisions imposed by the lender if:
1. Borrower has defaulted on the insured loan and HUD has received notice as required by the regulations;
  2. HUD determines that the project has been experiencing a net income deficiency, which has not been caused solely by management inadequacy or lack of owner interest, and which is of such a magnitude that the borrower is currently unable to make required debt service payments on the insured loan, pay all project operating expenses and fund all required HUD reserves;
  3. HUD finds there is a reasonable likelihood that the Borrower can arrange to refinance the defaulted loan at a lower interest rate or otherwise reduce the debt service payments through partial prepayment; and
  4. HUD determines that refinancing the defaulted loan at a lower rate or partial prepayment is necessary to restore the project to a financially viable condition and to avoid a full insurance claim.

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## Chapter 12 Construction Period

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### 12.1 Start of Construction – Sections 221(d)(4), 220 and 241(a)

- A. Start of initial construction is the date when contract work commences. It must be diligently pursued without appreciable delay between activities and includes site clearance and other preparatory site work.
- B. Early start of construction may be authorized in accordance with early start procedures (see Section 5.8.F). Where it occurs:
  - 1. A pre-construction conference is required before the start of initial construction;
  - 2. Construction inspections and change orders must be completed in accordance with this chapter;
  - 3. Authorization of any insured advances cannot occur until the endorsed instrument is recorded at initial closing.

### 12.2 Pre-Construction Conference

A pre-construction conference is required for every project and must precede the initial start of construction, including early start of construction. The HUD Inspector is an independent third party contracted out for the monitoring of the construction and renovation of multifamily housing projects that are insured by the Department of Housing and Urban Development. The HUD Inspector usually conducts the pre-construction conference and should hold it at initial endorsement where feasible, with the required participants present. The pre-construction conference may be conducted by the HUD Construction Manager (or designate), if the HUD Inspector is unable to attend, and may be scheduled shortly before or after the initial endorsement if necessary.

- A. Required attendees:
  - 1. Borrower's representative;
  - 2. Borrower's supervisory Architect;
  - 3. General contractor;
  - 4. Major subcontractor(s);
  - 5. HUD representative;
  - 6. HUD Underwriter; and

7. Lender's representative.
- B. Supplementary Conditions of the Contract for construction, Form HUD-92554M. The HUD representative must address Davis-Bacon wage rates, Federal labor standards and equal employment provisions, including:
1. Contract obligations of the general contractor and all subcontractors, including:
    - a. Certification of compliance with Davis-Bacon wage rates with each request for advances.
    - b. That Davis-Bacon wage rates are applicable to a second mortgage securing a governmental loan.
  2. Statement of sanctions that may be imposed for not complying with the supplemental conditions.
  3. Requirement that the applicable Davis-Bacon wage decision and the Form HUD-92554M must be made part of the subcontracts for all tiers.
  4. Emphasize the importance of Federal wage payments, prompt certified payroll submissions and proper record keeping. Instruct that a copy of the applicable Davis-Bacon wage decision and Form WH-1321, Notice to Employees, must be conspicuously posted on the job site.
  5. Indicate who on the HUD Labor Standards and Enforcement staff will review for labor standards compliance and refer any further inquiries concerning Davis-Bacon wage and reporting requirements to that staff.
  6. Provide the general contractor and the subcontractor(s) with the URL to obtain the Equal Opportunity poster with instructions to post conspicuously at the job site.
  7. Make available copies of HUD's Contractor's Guide to Davis-Bacon.
- C. Contract Administration
1. Explain general contract administration, including responsibilities of the lender, borrower, borrower's Architect, general contractor, and HUD representative.
  2. Explain the procedures for:
    - a. Change orders;
    - b. Requesting construction document clarifications;
    - c. Reporting and correcting non-compliant work;
    - d. Requesting periodic payments and release of escrows;
    - e. Substantial completion of work or portion thereof; and;
    - f. Permissions to occupy, including management plans and rent rolls.
  3. Stress that work changes completed in anticipation of a future change order will be regarded as non-compliant. There will be no insured advances for it or other work dependent on it.
  4. Periodic advances. Explain:
    - a. Borrower's and general contractor's required preparation of requests, including the field approval and subsequent processing;
    - b. Provisions for submitting surveys, title reports, and other documentation in support of construction advances;

- c. Requirements for contractor's retainage and its release.
  - 5. Stored materials. Explain procedures to request payment for materials stored onsite, and components stored offsite where applicable. (See Appendices 12B and 12C)
  - 6. Offsite work. Explain procedures to request payment for completed offsite work, the required retainage and its release.
  - 7. Termination of contract(s). Discuss provisions for terminating the construction contract and/or Architect's contract, and the lender's responsibilities during the construction stage and in the event of a default.
- D. Cost Certification
- 1. Summarize cost certification requirements for the mortgagor and (if applicable) the general contractor, subcontractors, equipment lessors and suppliers, and industrialized housing manufacturers. Where there is a second mortgage securing a Governmental loan, advise that cost certification also applies to the second mortgage.
  - 2. Inform all parties that a pre-cost certification conference will be held when construction is 90% complete and that detailed instructions will be provided at that point.
  - 3. Stress that:
    - a. Identities of interest that develop or become known after initial closing must be reported to the lender and to HUD within 5 working days of having such knowledge;
    - b. HUD must give prior approval for all identity of interest subcontractors and apply penalties where this is not done;
    - c. Self-owned equipment must be certified; and
    - d. Paper conduits are prohibited.
  - 4. Clarify the 50/75 percent rule (see Section 13.16).

## **12.3 HUD Construction Monitoring**

- A. Purpose of Inspection.
- 1. Inspection means the periodic observations made of rehabilitation/ construction at the site of a multifamily housing project by a HUD representative (inspector) for the purpose of protecting HUD's interests. Inspections are made to evaluate the contractor's and Architect's performance, to confirm construction is in accordance with the contract documents and to report on conformance with prevailing wages and other contract requirements.
  - 2. The instructions for inspection are the same for projects involving the insurance of advances and those to be insured upon completion, except for those variations specifically stated to be applicable to one or the other.
- B. Access. At all times, HUD has the right of access to the property and the right to inspect all work performed and materials furnished to complete the project.
- C. HUD Construction Manager's duties. The HUD construction manager (CM) or architectural designee is responsible for the proper performance of all functions relating to inspection, as well as the

instruction and coordination of all HUD personnel involved. The CM must be kept informed of the general progress of the work on all projects during the construction stage and guarantee period and must be familiar with the problems involved.

1. Assignment. The CM will assign either a HUD construction analyst or a contractor to inspect a project before the start of construction. The person inspecting the project may be a Design Representative, a Construction Representative, or a person or group hired by HUD to do the inspections, referred to as an "inspector." The CM will select the inspector on the basis of competency with regard to the scope of the project and to the type of construction involved. Several projects being constructed concurrently may be handled by one inspector. Only in very unusual circumstances will an inspector be assigned full time to any one project. Upon assignment, the CM will issue to the inspector the following:
  - a. Set No. 3 of the contract drawings and specifications. This set becomes the HUD as built set for the inspector to conform it to the contractor's "Record Set."
  - b. Copy of the construction contract. The required Contract for insured advances is the HUD Construction Contract, HUD-92442M, which contains alternate provisions for cost plus and lump sum contracts. The form may or may not be used in insurance upon completion cases, but a construction contract in some form is required and must be furnished to the inspector.
    - (1) Form HUD-92442M, Construction Contract-Lump Sum, may be used when there is no identity of interest between the borrower and the contractor.
    - (2) Form HUD-92442M, Construction Contract-Cost Plus, may be used in any case, and shall be used when an identity of interest exists between the borrower and contractor.
  - c. Owner-Architect Agreement, AIA Document B-108, when an Architect is required to administer the construction contract.
  - d. Contractor's and/or borrower's cost breakdown - Schedule of Values, Form HUD-2328 when insured advances are involved.
  - e. Drawings and specifications pertaining to off-site improvements.
  - f. Agreements or contracts providing for off-site construction.
2. Field Supervision. The CM shall keep informed of the general quality of inspections and the performance of inspectors by maintaining close contact with their work through job site visits. A regular routine for supervising field operations should be established and followed. Required methods of field supervision follow:
  - a. A minimum of one (or more where appropriate) field review inspections may be made on each project to evaluate the performance of the HUD inspector. Field review inspections shall be recorded on a HUD Representative's Trip Report, Form HUD-95379.
  - b. Construction should be field reviewed where the use of questionable methods of construction, materials, uncorrected non-compliance, or other problems are reported.
  - c. Projects should be field reviewed at construction stages where problems have occurred in that jurisdiction.
3. Office Review. The CM shall review all Trip Reports, Forms HUD-95379, completed by the HUD Inspectors. If the reported conditions indicate the necessity or desirability of field review or other special handling, appropriate action shall be initiated.

- a. Review should not be restricted to the entries on the report. The absence of significant evaluation comments may, under certain circumstances, indicate desirability of field review.
  - b. The CM should be aware of progress, trends, new or uncorrected non-compliance, unusual conditions, etc., in order to be familiar with the work and to initiate any required corrective action immediately.
  - c. The HUD Inspector shall be advised of any unsatisfactory action or detail in the report, or any error in its preparation, so that similar mistakes will not occur in the future.
4. Training.
- a. Inspection conferences shall be held when deemed necessary by the CM. The purpose of the conference is to maintain and improve the quality and efficiency of the construction observation function.
  - b. Field and office review of inspections will indicate individual training needs and subjects for discussion at inspection conferences.
  - c. It is essential that new inspectors and new staff be trained in the field as well as in the office.
5. Construction progress meetings. During construction, the contractor, mortgagor, mortgagor's supervisory Architect and the HUD inspector must attend monthly job meetings at the job site when monthly requests for advances are prepared.
- a. The owner's representative must be a member of the borrower entity, usually a general partner or managing member. Non-profit organizations may be represented by an executive officer or member of the Board of Directors.
  - b. The HUD Inspector must:
    - (1) Comment to the group on the quality of construction and of the Architect's observations and the contractor's supervision.
    - (2) Comment on all known construction defects and deficiencies (non-compliance) and methods of correction.
    - (3) Explain that changes in the work from the contract documents (non-compliance) must be resolved by approved change order requests or the work done in accordance with the contract documents. All change orders must receive prior approval before work subject to the change order is commenced.
    - (4) Inform parties of HUD policy for holdback of construction advances until non-compliance is corrected.
    - (5) Record on Form HUD-95379 the issues raised at the meeting. Significant concerns of any party should be presented by memorandum through the CM to the Regional Center Director.
  - c. Monthly meetings may also be used to resolve equal opportunity and labor disputes. When such disputes are known, the HUD Labor Standards and Enforcement and Equal Employment officers must be invited to attend.

D. HUD Inspector's Duties. The inspector is a HUD representative, not a superintendent for the contractor or "clerk of the works" for the owner or Architect. The inspector, as HUD's agent, must endeavor in a tactful, helpful and courteous manner to obtain construction that conforms to the drawings, specifications, and sound construction practice within the scope of the contract. The inspector must be factual and specific in all statements in reporting and recording significant construction developments observed.

1. Orientation. Upon assignment to a project, the inspector will study the drawings and specifications and become familiar with the conditions at the site. If, during this examination or during construction, any nonconformity with HUD requirements or site conditions not considered in the design is found, they are to be reported by memorandum through the CM to the Regional Center Director. The Regional Center Director will work with the lender, owner, contractor and other related parties to resolve the noncompliance.
2. Facilities. The contractor must furnish the inspector with enclosed working space that is acceptable to HUD. Adequate, but not elaborate, facilities should be required as soon as actual construction begins at the site.
3. Inspections. The inspector shall make one job site visit each month, except when HUD determines no inspection is necessary due to the progress of the work in a particular period. Additional visits may be necessary due to the nature of the project. The frequency of inspection should assure reasonable continuity and recognize the size and character of the project, the speed with which construction is progressing and the quality of work on the project. Visits should be scheduled to observe major construction operations without neglecting lesser operations. Sufficient time must be allotted to each visit to make a complete inspection.
  - a. The major functions during inspection are to: Evaluate the construction supervision of the contractor and contract administration of the Architect; report on occupancy, delays, disputes, and changes; review completed units and execute the Form HUD-92485 Permission to Occupy as required; report noncompliance with the contract documents observed by the inspector and/or the supervisory Architect; determine that the amounts requested by the contractor and recommended by the Architect for payment are reasonable; conduct employee wage interviews using Form HUD-11; and report on labor and EEO compliance.
  - b. Each inspection shall be recorded on a HUD Representative's Trip Report, Form HUD-95379.
  - c. Reporting requirements. The following documents executed during inspection must be promptly sent to the CM, the project Architect and the lender's Construction Loan Administrator:
    - (1) HUD Representative's Trip Report, Form HUD-95379:  
Original to the CM, with copies to the Architect and the lender's Construction Loan Administrator.
    - (2) Contractor's Requisition, Form HUD-92448:  
Original to the lender's Construction Loan Administrator for signature with copies of the signed document to the CM, the Architect and the HUD inspector.
    - (3) Change Order Form HUD-92437:  
Original to the lender's Construction Loan Administrator for signature with copies of the signed document to the HUD CM, the Architect, and the HUD inspector.

(4) Permission(s) to Occupy, Form HUD-92485:

When all required signatures (mortgagor, architect, and contractor, mortgagee, and HUD inspector) are affixed, the document will be sent to the HUD CM for approval. Upon signing by the FHA authorized agent, copies are sent to the lender's Loan Administrator, the Architect, and the HUD inspector.

4. Start of Construction. The inspector will report the date of initial construction start and the date of the start of permanent construction on Form HUD-95379.
  - a. The date of the initial construction start, used for recording and reporting purposes, is the "start of construction" as used in connection with labor standards and prevailing wage requirements. This is defined as the beginning of initial site clearance and preparation, provided these activities are pursued diligently and are followed, without appreciable delay, by other construction activities.
  - b. The date recorded as the start of permanent construction, used for the purpose of determining the earning of the inspection fee, will correspond to the first day that permanent on-site building elements were put into place, such as footings and/or foundations, pilings, utility lines, etc.
  - c. While excavation is an integral part of foundation work, it does not constitute a start of permanent construction.
5. Unified Report. At the beginning of construction, the inspector should consult with the HUD Design Representative and the CM in regard to the need for inspection of the project by HUD technical specialists. Any differences of opinion between the inspector and the technical specialist in regard to project construction will be resolved by the CM. The inspector must submit a unified inspection report to the Architect and the lender.
6. Shop Drawings and Other Data. During the construction period, the inspector must check whether shop drawings are being submitted by the contractor for approval by the Architect as required by the AIA General Conditions of the Contract. Upon request by the Architect or the inspector, the contractor will keep copies of tests, certifications and any other data required by the contract documents onsite for review.
7. Off-site Fabricated Construction. If off-site fabricated construction components are involved, the CM will determine if there is a need for inspection at the factory to determine acceptability. If the manufacturing facilities are outside of the jurisdiction of the HUD Office and inspection is essential, the CM will submit pertinent drawings and specifications, together with a request to the Regional Center Director to have the inspection made by the HUD Office located near the factory.
8. Distribution. If an Architect is not required for contract administration, then where these instructions require the HUD inspector to submit findings to the Architect, they are to be submitted to the contractor.
9. Work Stoppage. The HUD inspector will report to the CM on Form HUD-95379 any work stoppage unless such stoppage is due to inclement weather or similar reasons. If known to the inspector, the reason for the work stoppage should be stated and when resumption of construction is anticipated.
10. Occupancy. The HUD inspector will complete the portion, "FHA Inspection Report," of Form HUD-92485, Permission to Occupy, when submitted, to request permission to rent or occupy specific living units, commercial or other space. The Form is to be submitted when the inspector

reports safe ingress and egress to the units and/or building, as evidenced by a certificate of occupancy from the locality. In the event that scheduling does not permit the inspector to inspect the completed units on a timely basis, then the CM may authorize the Architect to issue a phased Permission to Occupy on condition that the Contractor will inspect the completed units at the next regularly scheduled site visit. Units and spaces should not be occupied prior to approval by HUD. The Regional Center Director and MAP Coordinator should determine who in the Regional Center or Satellite Office will approve the permission to occupy.

- a. Occupancy prior to the execution of Form HUD-92485 will be reported to the Regional Center Director by written memorandum.
- b. The inspector will also include on the Form HUD-95379, the number of units occupied prior to approval, as well as the date occupancy took place.

11. Additional duties of the `inspector:

- a. Advises the Architect administering the construction contract on HUD requirements;
- b. Reviews the Architect's job log;
- c. Reviews copies of the Architect's decisions;
- d. Reports on project construction progress to the CM on Form HUD-95379;
- e. Notifies the Architect and the contractor if an identity of interest exists between the owner and the contractor, or if it is determined that there are any essential variations in the cost of the work installed, materials stored and the request for construction advances recommended by the Architect; and
- f. Conducts interviews with an appropriate sampling of the laborers and mechanics engaged and records interview information on Record of Employee Interview, Form HUD-11, in connection with wage and labor compliance in the construction of the project.

12. Construction record. From the initial construction start through final inspection, the inspector shall be responsible for maintaining a record of construction that includes minutes of the pre-construction conference as well as reports of required guarantee inspections. The inspector shall keep a record binder when the CM first assigns the project or may elect to expand the project record binder to include inspection reports. All forms, reports, decisions and documents relevant to construction or inspection reporting shall be recorded in the binder in chronological order. The journal shall be on the left side of the binder and forms and documents on the right. The forms and documents listed below shall be included in the Construction Inspection Record Binder, when applicable.

- a. Drawings and specifications: Sets 1, 2, and 3 referenced in journals though filed elsewhere (record the storage location of set 1 and use of 2 and 3).
- b. Off-site drawings and specifications (referenced in journal).
- c. Construction Contract, Forms HUD-92442M.
- d. Owner-Architect Agreement.
- e. Progress schedule.
- f. Contractor's and/or borrower's Cost Breakdown, Form HUD-2328.
- g. HUD Representative's Trip Report, Form HUD-95379.
- h. Contractor's Requisition, Form HUD-92448.

- i. Change Orders Form HUD-92437, AIA G710, and Architect's supplemental instruction or equivalent.
  - j. Letters, memoranda, notes, and worksheets.
  - k. Journal of Architectural Actions (if separate binder).
  - l. Surveyor's Report, Form HUD-91073M (final and others, if requested).
  - m. Permission(s) to Occupy, Form HUD-92485.
  - n. Record of established escrows including amounts escrowed and a complete list of unfinished construction items, record of call back inspections and recommendations for monies to be released.
13. Projects of Insurance upon Completion. The inspector will report the percentage of completion of the project on Form HUD-95379 at the end of each month. This percentage is an approximation for general information and is not used for disbursement.
14. Off-site inspection. The inspector checks all off-site construction for conformity with the terms of the contract and reports work progress by percentages on Form HUD-95379. Completion is reported on Form HUD-92464.
- E. Reporting and dealing with serious construction problems. HUD Offices must identify and report, by electronic mail, to the Regional Center Director and AMCOD all insured multifamily projects under construction or in the guarantee period that have serious construction defects or other serious construction related problems. This information will be used to reply to inquiries, as an "early warning system" on troubled projects, and to determine if assistance by the HUD Office is necessary.
- 1. The inspector must identify all construction problems that may delay completion or lead to foreclosure or assignment of the mortgage to HUD by using Form HUD-95379, HUD Representative's Trip Report.
  - 2. The CM must prepare a referral memorandum to the Regional Center Director when:
    - a. Work stops for 20 calendar days;
    - b. There are slow payments or non-payments to the general contractor and/or subcontractors;
    - c. Contractor abandons the job;
    - d. Contractor, owner or Architect changes during construction;
    - e. Correction of any construction deficiency is not started within 30 days of the first notification to the contractor; or
    - f. Contractor can't or won't correct any construction defect or latent defect.
  - 3. The referral memorandum must include full details of the construction related problem, including:
    - a. A copy of Form HUD-95379, which identifies the problem.
    - b. The inspector's opinion of the cause and recommendation for correction.
    - c. A report of action by the CM and/or other HUD Office staff.
    - d. A report of actions by the owner, Architect, contractor, mortgagee and bonding company (when appropriate).

- e. A plan of action to be undertaken by the HUD Office if the mortgage is assigned to HUD during construction or foreclosure is initiated by the lender.
4. Only the initial report is required unless the Regional Center Director requests further action or follow-up by the HUD Office.
5. For complete instructions on handling problems before final closing, see Appendix 12D.

## **12.4 Architect's Duties in Administering Construction Contract**

The Architect shall:

- A. Provide services in accordance with the Owner-Architect Agreement.
- B. Have no identity of interest with the owner or contractor. An identity of interest is defined in the HUD Amendment to the B108, Owner-Architect Agreement.
- C. Ensure that construction is carried out in accordance with the contract documents, including:
  1. Restrict materials, products and equipment to those specified.
  2. Restrict all deviations to those substantially consistent with the original design concept including form, color, and texture.
  3. When arriving at the net amount due on every requisition, compare the cost of the work and materials with the cost to complete the project. Current and previous payment must relate to the total cost for completion.
  4. Restrict substitution of items of a different design or size from those specified to those that are equivalent in utility (i.e., durability, quality, and ease of maintenance).
  5. Restrict substitution of any material differing in composition or appearance from the one specified to one which is equivalent in its attributes (i.e., character, quality, durability and ease of maintenance).
  6. Keep a log on the site that is readily available to the mortgagor and HUD representatives.
- D. Architect's supplemental instructions. The architect administering the construction contract may issue field orders using AIA Document G710, Architect's Supplemental Instructions, or a similar form.
  1. The architect must send a copy of each supplemental instruction to HUD, although prior approval by the lender and HUD is not required.
  2. Supplemental instructions must not involve a change in contract sum or contract time.
  3. Supplemental instructions may be used to:
    - a. Direct the contractor to bring construction into compliance with the contract documents.
    - b. Interpret or clarify the contract drawings and specifications.
    - c. Order minor changes in the work, not involving cost.
    - d. Accept specified equivalents.
    - e. Record other "field orders" that are not construction changes.

- E. The Architect administering the construction contract is responsible for reporting in writing the results of periodic visits to the construction site. The Architect's log should provide information regarding assessment of the progress of the work and a record of the actions taken to insure that the work is being accomplished in the best interests of all the parties.
1. The American Institute of Architects (AIA) Document G711, Architect's Field Report, may be used for the log.
  2. A log of each visit should show, at a minimum, the following:
    - a. Date of inspection.
    - b. HUD project identification and location.
    - c. Time, weather, and temperature range.
    - d. Estimated percent of completion.
    - e. Work in progress and conformance with the contractor's progress schedule.
    - f. Persons present at work site.
    - g. Observations and items to verify.
    - h. Information or action required.
    - i. Firm name and signature.

## **12.5 Architect's Adequacy**

The Architect's administration of the construction contract is covered by the Owner-Architect Agreement and by the General Conditions of the Contract for Construction, AIA Document A201. The HUD inspector is responsible for determining the adequacy of the Architect's administration, which determination will not be based just on the number of visits or the length of time spent by the Architect on the job, but on whether the construction complies with the contract documents based on the Architect's observations.

- A. Deficient administration. If the Architect does not report all observed non-compliances with contract documents and unacceptable performances by the contractor and pursue all avenues to obtain compliance with the contract, then the Architect's administration of the construction contract will be considered deficient. The Architect will not be responsible for actual construction, construction means, methods, techniques or other related responsibilities of the contractor. However, on the basis of on-site observation as the owner's representative the Architect must keep the lender, owner and HUD informed of the progress of the work and endeavor to protect the owner and HUD against defects and deficiencies in the construction.
- B. Reasons for termination of services. Inadequate performance, undue delay, misrepresentation or failure to act on the part of the Architect or the Architect's associates and employees shall be reason for the termination of the Architect's services on the project and may adversely affect the firm's acceptability on future projects.

- C. HUD office actions. The HUD inspector shall bring to the attention of the Architect specific areas in which services are considered deficient. Sufficient time and appropriate assistance shall be given to obtain necessary compliance.
1. When the Architect's performance is first observed as deficient, in addition to the HUD Representative's Trip Report, Form HUD-95379, the inspector shall also prepare a written memorandum to the CM of the deficiency and advise of any planned actions or assistance. The memorandum should recommend that future requests for Architectural inspection fees be disallowed until performance improves to an acceptable level.
  2. An immediate follow-up by the CM is always required. Conferences with the inspector and the Architect should be arranged and a target date established for the Architect to obtain compliance. The CM shall inform the Regional Center Director of current problems and of established target dates for corrections. Deficiencies related to misrepresentation, undisclosed identity of interest and known illegal kick-backs should be immediately referred to the local HUD Office of General Counsel with a copy to the Regional Center Director. The local HUD Office should clearly document all actions.
- D. Request for contract termination. When compliance with the contract cannot be obtained within 30 days, the Regional Center Director shall request termination of the Architect's contract in accordance with the provisions of the AIA Document B108 Owner-Architect Agreement. Upon termination, the Architect shall be entitled to only the prescribed portion of the fee determined by the percentage to which construction was completed on the date that the Architect was removed from the project. The Regional Center Director has full authority to secure acceptable performance.
- E. Contract termination. The owner will hire an independent Architect who is acceptable to all parties to continue the administration of the project construction documents. The HUD inspector does not assume the Architect's responsibility.

## **12.6 Completion Inspections**

- A. Substantial completion. The Architect will date and sign the certification on Form HUD-92485, Permission to Occupy, for that part or for all the work that is sufficiently complete, in accordance with the contract documents, and may be occupied for the use intended.
1. The contractor must submit a punch list of items to be completed or corrected to the Architect when the work is ready for occupancy. (See Article 9.8, AIA Document A201.)
  2. The Architect will inspect, check the punch list and modify it if necessary, and determine when the work is substantially complete. (Dwelling units containing punch list items will not be accepted for occupancy. However, punch list items in interior common areas and on the exterior do not preclude occupancy.)
  3. Certificate of Substantial Completion: The HUD inspector will verify on Form HUD-92485 the date that the work, or a portion of the work, is substantially complete and suitable for occupancy. Where the Owner/Architect Agreement and the General Conditions of the Construction Contract, AIA Document A201, refer to a Certificate of Substantial Completion, it confirms that the

Permission to Occupy Project Mortgages, Form HUD-92485, was executed. The date of substantial completion of the project is the date that the HUD Representative signs the Permission to Occupy for the final building or for the portion of the work that is completed.

4. The Contractor's Guarantee Period commences with Substantial Completion of the Project as defined in Article 3.B of the Construction Contract, HUD-92442M which takes precedence over AIA Document A201, Article 9.8.4, and stipulate that warranties commence with the substantial completion of each portion of the work.
- B. Final completion inspection. The Architect and inspector will make the final inspection upon written request of the contractor, and may do so separately.
1. The Architect must determine that all punch list items have been completed unless they are beyond the control of the contractor (i.e.: items of delayed completion).
  2. The inspector must prepare the final inspection report on Form HUD-95379 which includes:
    - a. Reports onsite construction completion, although there may be items of delayed completion.
    - b. Lists and describes any items of delayed completion.
    - c. Lists any offsite work and reports the percentage of completion for each.
  3. The HUD Construction Manager/Coordinator will check the final inspection report to determine:
    - a. If unacceptable and, requires re-inspection (i.e.: the report is not considered final).
    - b. If acceptable, the report will be endorsed as follows:
      - (1) "Construction acceptably completed." (If there are items of delayed completion, add, "subject to escrow of funds to assure completion of listed items of delayed completion.")
      - (2) "All offsite sewer, water, electrical and gas facilities are completed, connected and operable, and safe, adequate, all-weather ingress and egress provided." (If offsite item incomplete, add, "except as stated at the time of inspection.")
      - (3) Date and sign the report.
    - c. CM will prepare a memorandum for signature by the Regional Center Director transmitting the final inspection report, which:
      - (1) States the date of final completion (i.e.: the date of final inspection);
      - (2) Lists incomplete offsite work; and
      - (3) Lists items of delayed completion and the estimated of cost of completion for each item.
- NOTE:** The escrow for items of delayed completion must not be less than 150% of the estimate to complete and must not exceed 2% of the mortgage. Work must be completed within the time specified in Form HUD-92456M, Escrow Agreement for Incomplete Construction, but not more than 12 months from the date of the final HUD inspector's trip report.
- C. Guarantee inspections. Inspections to ensure correction of latent defects (defective or nonconforming work not observed during construction) or to check any item of delayed completion will generally not be required or expected to be performed by the inspector. HUD has the option of requiring such

inspections on particular transactions. For those transactions where such inspections are requested by HUD, they should be performed within 1 year of the date of final completion and the following requirements will apply:

1. The CM/Coordinator will schedule guarantee inspections as follows:
  - a. The first inspection must be within 9 months of final completion and should provide for inspection of the entire project.
  - b. Other inspections may be necessary to assure inspection of seasonal items such as heating and landscaping.
  - c. The last inspection must be not later than the 10th day of the 12th month to check previously reported defects and their correction, and to identify any additional defects.
  - d. The nine and twelve month warranty inspections are to be attended by the Architect, Owner and General Contractor. Copies of the Architect's Field Reports for these inspections are to be forwarded to both HUD and the Lender.
2. The Architect must report each guarantee inspection on Form HUD-95379, including:
  - a. If work is acceptable, state, "All observable work acceptable at the time of this inspection."
  - b. If unacceptable, list latent defects.
    - (1) Describe each item.
    - (2) Recommend method of correction.
    - (3) Estimate current cost of correction.
  - c. Check any item of delayed completion and list complete and uncompleted items under a separate heading.
  - d. Note any improper maintenance or casualty damage under a separate heading.

## **12.7 Insurance of Advances and Related Matters**

### **A. General.**

Insurance of advances is the process of releasing insured mortgage funds and other funds necessary for the construction, acquisition and/or refinancing of the project. The following general criteria apply to the advancing of such funds.

1. All escrowed funds for on-site improvements (with the possible exception of grant/loan proceeds furnished by a government agency or instrumentality or tax credit equity proceeds) must be disbursed before mortgage proceeds. See Chapter 14 for instructions on the pro-rata disbursement of tax credit equity proceeds. EB-5 Investments must be funded in advance, in the same way as other equity sources, and are not eligible to be disbursed on a pro-rata basis. .
2. The amount of construction funds approved and advanced for insurance must be consistent with construction progress as approved by the HUD Field Representative.
3. Other mortgageable items must be adequately documented with bills and/or receipts before funds can be approved and advanced for insurance.
4. The amount advanced for construction items must be adjusted for a 10% holdback until 50% completion then reduced per Section 12.15.A.3 below.

5. The final amount approved for insurance must be supported by certified costs recognized in the cost certification review. Projects that are exempt from the cost certification process can submit a copy of their final Sources and Uses Statement prepared by the allocating State Housing Finance Agency for HUD's review of the final sources and uses amounts.
6. The Application for Insurance of Advance of Mortgage Proceeds, Form HUD-92403, is initiated by the mortgagor. The initial and final advances must be submitted by the mortgagee to HUD for review and approval. Interim advances are approved by the mortgagee, based upon the HUD Inspector's approval of the construction amount. The approved Contract Administrator must sign forms HUD-92403 and HUD-92448 in the Authorized HUD Official signature block.
  - a. For the initial and final advances, the PC Director must sign Forms HUD-92403 and HUD-92448, in the following spaces:
    - (1) Under Authorized HUD Official for Form HUD-92403, and
    - (2) Under Director, Housing Production for Form HUD-92448.
  - b. For the interim advances, the lender (by either the lender's underwriter or construction loan administrator) must sign Forms HUD-92403 and HUD-92448 for HUD, in the same spaces as in 6.a (1) and (2) above.
7. Supporting materials to Form HUD-92403 include supporting bills/receipts and Form HUD-92448, Contractor's Requisition, if requesting construction funds.
8. Please see the FHA Multifamily Program Closing Guide for additional requirements related to title and survey matters.

B. Lender's role in processing HUD-92403 includes:

1. Complete the application indicating:
  - a. Amount requested by mortgagor;
  - b. Approximate disbursement date;
  - c. Amount to be advanced from mortgage proceeds;
  - d. Amount disbursed from mortgagee's front money escrow, if any; and
  - e. Total loan proceeds disbursed including the current request.
2. Submit the initial and final application to HUD for review and approval.
3. Process and approve interim advances.
4. Ensure clear title before advancing the approved disbursement.
5. Notify HUD in writing when clear title does not exist or is impaired.

C. Stages of Advances.

In cases involving insurance of advances, HUD and the lender's processing of the advance is divided into the following stages:

1. Initial advance. Refers to the first application and coincides with the initial endorsement of the mortgage. The initial advance will be reviewed and executed by the HUD mortgage credit analyst. The lender should submit Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, with supporting documentation for HUD approval.

2. Interim advances. Interim advances are subsequent applications up to completion of the project and will be processed and approved by the lender.
  3. Next to Final Advance. When HUD is in receipt of the contractor's certification and the consent from both the mortgagor and surety, if any, the final 5% of the construction holdback is released.  
Note: This procedure only applies to non-identity of interest contractors or where the contractor's identity of interest in the project ownership is less than 5%.
  4. Final Advance. This refers to any remaining balance of mortgage proceeds at final endorsement and takes into consideration funds necessary to set up the escrows for "Items of Delayed Completion" and "To Be Paid in Cash Items" and will be processed by HUD. In addition to the Form HUD-92403, the lender must submit a copy of Form HUD-92451 Financial Record of Mortgage Loan Transaction, which reflects releases to the various payees during the construction period.
- D. Instructions for Approval of Initial/Interim Advances can be found in Appendix 12A.
- E. Contractor's Monthly Requisition and Related Matters. See Appendix 12B for instructions on completing Contractor's Requisition, Form HUD-92448, and related matters.
- F. Next to Final Advance. The lender may request the next to final advance when construction is acceptably complete, even if there are items of delayed completion.
1. It may provide for the release of the contractor's holdback provided the conditions in Section 12.15.D have been met. The amount approved for release will be based on the cost certification review and HUD-approved amount (or where the cost certification is exempt, an operating statement is reviewed instead). The amount approved for release will also consider items of delayed completion. A special condition will be included in the Firm Commitment in the event that the cost certification is exempt and an operating statement will be reviewed instead.
  2. The balance of the off-site escrow may be released upon HUD approval provided:
    - a. The off-site sewer, water, electrical and gas facilities are completely installed and connected; and safe and adequate all weather facilities for ingress and egress are provided.
    - b. All other required off-site construction, if any, is completed.
    - c. Otherwise, completion is to be assured by a cash deposit in an amount equal to 150 percent of the HUD estimate of the cost of such remaining off-site construction.
- G. Final Advance. The Application for Insurance of the Final Advance will request any remaining balance of mortgage proceeds and ensures that:
1. The mortgagor's cost certification has been approved and the maximum insurable mortgage amount determined using Form HUD-92580, Maximum Insurable Mortgage.
  2. Form HUD-92403 is accompanied by a completed Form HUD-92448, with required Contractor's Prevailing Wage Certificate, if the contractor's holdback has not been previously disbursed. Refer to Section 12.15.E for instructions on releasing the contractor's holdback.
  3. The sum to be approved for the advance is the balance of the mortgage proceeds, based on the maximum insurable mortgage on Form HUD-92580. Refer to Section 13.12 for instructions on an advanced amortization adjustment, if any.

4. An escrow is established for incomplete or delayed construction items under the provisions of Form HUD-92456M, Escrow Agreement for Incomplete Construction (formally Escrow Deposit Agreement for items of delayed completion).
5. Form HUD-92023M, Request for Final Endorsement of Credit Instrument, or Form FHA-2453, Commitment to Insure upon Completion, must have been submitted and reviewed.
6. Setup the escrow for the mortgagor's unpaid construction costs under the provisions of Form HUD-92476.1M, Escrow Agreement for Non-Critical, Deferred Repairs, (formally Escrow Agreement for Unpaid Construction Costs, Repairs or Needs Assessment Repairs).

H. Keeping the mortgage in balance.

Soft cost overruns such as interest, taxes, mortgagee insurance premium (MIP), and insurance that result from a construction delay before completion of the project and which is the fault of the general contractor, (i.e., due to poor performance), are funded according to the liquidated/actual damages clause in the construction contract. This clause is not intended to penalize the contractor, but to provide a source of funds for the increased soft cost. When the interest allocation is near exhaustion (*i.e. when the balance after several draws is \$1,000 or less*) the lender must notify HUD immediately, and HUD will advise the lender of the following procedures:

1. When the interest allocation is near exhaustion, have the Architect and the HUD inspector estimate an expected completion date.
  - a. Compute the minimum liquidated damages for the period between the completion date specified in the construction contract, as adjusted by approved change orders, and the estimated completion date.
  - b. When the interest allocation has been exhausted, the non-profit developer's fee, if applicable, or the working capital escrow should be used to keep interest current.
  - c. Transfer the computed liquidated damages amount from column I, Construction, to Column G, Carrying Charges and Financing, on Form HUD-92451 and:
    - (1) Allocate the full amount to interest, initially.
    - (2) Funds may be used for MIP, taxes, or insurance payments, if requested, after the funds for these line items and non-profit developer's fee, if applicable and working capital escrow are exhausted. However, funds transferred from the construction account may be used to cover only the cost of those items attributable to the period in paragraph 1 above, specified in the construction contract and the assumed completion date.
2. Notify the borrower, contractor, HUD and the surety, if any, by certified mail of the amount and the reason for the transfer.
3. Require written acknowledgment from HUD and surety, if any, before transferring funds.
4. The amount of transferred funds must be reflected on subsequent Forms HUD-92448 as a decrease to item 7, *Sum of Cost Breakdown Items Plus Inventories of Materials*.
5. After review of the cost certification documents, if the full amount of transferred funds was not needed to cover the cost of interest, MIP, taxes, and insurance attributable to the period identified, the balance will be transferred back to the construction account.

6. In processing Form HUD-92448, before releasing the general contractor's holdback, make adjustment for the lesser of actual or liquidated damages determined in the cost certification review.
7. This procedure should be used only if, in consultation with the Regional Center Director, it is determined that the problems causing the delay will be remedied within the near future.

In the event the project continues to sustain an imbalance between sources and uses of funds, the Regional Production Office will inform the Regional office of Asset Management about the issues and the status of any release of IOD funds.

## **12.8 Construction Change Orders – General HUD Duties**

- A. General instructions. Construction contract changes to the scope of contract work, contract price or contract time must be requested by the mortgagor through the lender on Form HUD-92437, Request for Construction Changes and must be signed by the mortgagor's Architect, the mortgagor, the general contractor and the lender before HUD reviews the change order for approval.
  1. HUD review and approval. Each HUD discipline as appropriate, including Architecture, Cost, Appraisal, Mortgage Credit and the HUD Inspector may review and make a recommendation to the HUD CM.
  2. Change orders will be approved only when they are necessary, are for betterment or an equivalent. The following information should appear on the face of the change order:
    - a. Classification (necessity, etc.);
    - b. Qualification for payment from the contingency reserve and from the developer's fee for non-profit borrowers; and
    - c. Whether the change order results from error, omission or negligence on the part of the Architect, contractor or mortgagor.
  3. Change orders submitted after the final HUD Representative's Trip Report will not be approved, except where:
    - a. The change order pertains to "Items of Delayed Completion," or
    - b. Written approval is given by the Regional Center Director.
  4. Surety approval must be secured in writing before approving any change or aggregate of changes that increase the contract price by 10% or more. Surety consent is not required where the project's assurance of completion is by a cash escrow or letter of credit.
  5. Working capital new construction contingency. The working capital escrow requirement for new construction transactions is 4% of the mortgage amount, half of which (or 2%) is used as new construction contingency to fund necessary approved change orders, construction cost overruns and other cost overruns. At the borrower's request any unused portion is released after Final Endorsement.
- B. Other change order policies.
  1. Changes must be accurately reported and accounted for pursuant to U.S. Criminal Code, Section 1010, Title 18, U.S.C.

2. Procedures for changes outlined here are not to be used to alter the intent of the contract documents or to lower the quality or value of a project.
  3. HUD does not initiate any change but may require it as a condition of approval in connection with a change proposed by the Architect, mortgagor or contractor.
  4. All changes must be approved in writing by the lender and HUD before they are made.
  5. Any change that is made without formal approval, even though tentatively agreed to as technically acceptable, must be recorded by the HUD Inspector as a noncompliance until the Form HUD-92437, Request for Construction Changes - Project Mortgages, is approved. The payment of future insured advances may be affected until corrected.
- C. Change order classification.
1. Necessary changes (which the Construction manager or architectural designee must document) are those that arise from:
    - a. Latent conditions that differ from conditions defined by the construction documents;
    - b. Changes in the applicable state or local codes, ordinances, etc. after:
      - (1) Initial closing for insured advances; or
      - (2) Firm Commitment for insurance upon completion.
    - c. The Architect's errors or omissions.
    - d. Damage to completed construction.
  2. Betterment changes are those that are economically justified. They must either:
    - a. Increase net income;
    - b. Reduce long-term project maintenance and/or operating expenses; or
    - c. Otherwise enhance the mortgage security.
  3. Equivalent changes are those proposed because:
    - a. A specified item is not readily available and the substitution provides equivalent or better utility and performance, or
    - b. The proposed substitution reduces the contract price but provides equivalent or better utility and performance.
- D. Additive change orders. The lender must not give any explicit or implied assurance to the borrower or the contractor that an increase in the insured mortgage amount will be granted when construction changes are approved.
1. Lender must require the borrower, except for "necessary" change orders on substantial rehabilitation projects, to escrow funds with the lender for any additive change order where HUD first estimates that the aggregated change orders equal or exceed a \$5,000 increase in the construction contract price, and for all subsequent additive change orders. Non-profit borrowers may use the developer's fee to fund additive change orders.
    - a. Excess mortgage proceeds, if available, may be used to fund the escrow for necessary and betterment change orders. However, any excess mortgage proceeds used to fund the escrow for contractor estimated costs in excess of HUD estimated costs, or HUD estimated costs in excess of contractor

estimated costs, may not be disbursed until final closing. [Cross Reference Section 8.14.K and Appendix 12A para. D]

- b. The lender may accept a third party letter of credit instead of a cash deposit, subject to the lender agreeing to provide the cash equivalent, where the letter of credit is not immediately honored.
  - c. The lender may recognize the cost of third party paid change orders at cost certification, where there are available mortgage savings.
2. For substantial rehabilitation projects the lender must approve disbursements from the established contingency reserve in an amount not to exceed the HUD cost estimate for necessary or betterment change orders.
    - a. The lender must require an escrow for any amount that the contractor's cost estimate exceeds the HUD estimate.
    - b. The lender may authorize the use of excess mortgage proceeds, if available, to satisfy the escrow requirement, subject to the disbursement limitations in paragraph 12.8.D.1.a above.
    - c. After substantial rehabilitation work is complete and approved by the HUD Inspector and subject to lender and HUD approval, the borrower may elect to apply funds remaining in the contingency reserve line item to do:
      - (1) necessary, further improvements, betterments or upgrades to the property,
      - (2) an initial deposit to the Reserve for Replacement account, or
      - (3) a reduction to the principal mortgage balance.
  3. The lender must approve the following forms for mortgagor's application of funds for completed additive change orders:
    - a. Form HUD-92464M, Request for Approval of Advance of Escrow Funds, where an escrow is used, which must be submitted to HUD for approval.
    - b. Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, where a rehabilitation project's contingency funds or a non-profit's Developer's fee or excess mortgage proceeds are to be used.
- E. Deductive change orders. Where the HUD estimated decrease in contract price for any aggregation of change orders:
1. Remains less than 2-1/2% of the contract price, the lender must reduce the Contractor's "Final" Requisition, Form HUD-92448, by the appropriate amount.
  2. Equals or exceeds 2-1/2% of the contract price and for all subsequent deductive change orders regardless of the amount, the lender must:
    - a. Reflect the decrease in the Contractor's Requisition, Form HUD-92448, item 8.
    - b. Reduce the original mortgage amount at cost certification, where required.
- F. Changes that adversely affect property income are a basis for change order rejection, except where it is a necessary change order and the situation is unavoidable. HUD staff must adequately document the analysis and decision showing that the change resulted in less property income.
- G. Extension of contract time.
1. The lender may approve an extension only where:

- a. The delay is beyond the contractor's control (e.g. strikes, differing site conditions, bad weather exceeding the average for the season, etc.) and it is documented or associated with an approved change order,
  - b. The extension request is submitted within the limit provided by the contract and the general conditions for delays beyond the contractor's control, and submitted concurrently with any requested changes in the work, and
  - c. The request is accompanied by a Surety's written consent. There is no consent requirement where the project's assurance of completion is by a cash escrow or letter of credit.
2. The lender may require funding for the increased cost for overhead, interest, taxes, insurance, MIP and contractor's general requirements by use of a cash escrow, excess mortgage proceeds, or non-profit's developer's fee, if applicable, or from contingency reserve.
  3. HUD may enforce liquidated damages in accordance with the terms of the construction contract (Form HUD-92442M).
  4. Required documentation. Within 21 days of the date a construction delay occurs, the contractor must document the delay with the Architect and include:
    - a. Date of occurrence and number of calendar days it covered;
    - b. Effect on construction progress;
    - c. Cause of the delay. If the cause is of a continuing nature, submit the extension request when the cause ceases, but still record the initial date of occurrence and its effects on construction; and
    - d. The extension request must include the written consent of the Surety and conform to AIA Document A201, Article 8.3.
- H. Changes to items of delayed completion are the only construction contract changes that the HUD Representative may approve after project completion. All others require the Regional Center Director's consent.
- I. Emergency changes.
- The only time a change can be made without prior written approval of the lender and HUD is in emergencies that:
- a. Endanger life or property; or
  - b. Halt construction.
- However, even then, the Architect must notify the lender and HUD and as soon as possible, submit a Form HUD-92437.
- J. Insurance Upon Completion: Construction Contract Changes, Form HUD-92437, are to be processed in the same way as Insurance of Advance cases, except as modified below:
1. An escrow is not required for additive change orders. The borrower:
    - a. Must be able to provide the additional funds required, and,
    - b. Must not have any outstanding obligation in connection with construction other than the insured mortgage at the time the mortgage is presented to HUD for insurance upon completion.
  2. Surety approval is not required for the approval of additive change orders regardless of the percentage of contract increase.

- K. Changes to offsite construction must be requested by letter or other acceptable format with the information required by Form HUD-92437 used as a general guide, although the actual form must not be used.
- L. Other changes. Changes necessitated by error, omission or negligence of the Architect, owner, or contractor must be recorded by the HUD architectural staff or inspector, on Form HUD-92437, including.
  - 1. The reason for the determination; and
  - 2. Confirmation that the cost of the changes must not be included in the mortgage amount.

## **12.9 Change Orders – Inspection Instructions**

### A. General procedure.

**NOTE:** For projects involving insurance upon completion, references here to "contract requirements" or "contract documents" include the conditions and provisions of the commitment if there is no construction contract.

- 1. Any contemplated changes are first discussed among the Architect, contractor, owner, and HUD inspector.
- 2. HUD inspector will make a preliminary determination of technical acceptability before the change is submitted for approval to the lender and the HUD Office. (This neither commits HUD to the change, nor relieves the Architect or the contractor of having to submit Form HUD-92437.)
- 3. All onsite changes to construction documents and requests for time extensions must be submitted for approval on Form HUD-92437, Request for Construction Changes - Project Mortgages.
  - a. Required attachments for physical changes are:
    - (1) Appropriate modifications to the contract drawings and specifications;
    - (2) Architect's statement that the change:
      - (a) Conforms to the original intent of the contract drawings and specifications;
      - (b) Is necessary to overcome an impediment to construction, or is an addition desired by the owner.
    - (3) Backup documentation for the amount requested consisting of itemized quantities and costs.
  - b. The form must be signed by the:
    - (1) Borrower,
    - (2) Contractor,
    - (3) Architect (if an Owner-Architect Agreement is in effect), and

- (4) Authorized official for the lender.
- 4. All offsite changes to construction documents and requests for time extensions must be:
  - a. Requested in a letter or other format acceptable to the Regional Center/PC, but not on Form HUD-92437.
  - b. Documented and processed the same as on-site changes.
- 5. HUD will promptly review all requests submitted so delays will not affect construction or contractor requisitions.
  - a. Processing should normally take no more than 5 workdays and is directed by the CM.
  - b. All construction change requests must be reviewed, signed, and dated by the CM.
- 6. Voiding changes. If an approved change is not made, it must be nullified by a Form HUD-92437 restoring the drawings and specifications to the status prior to the change request or to a status acceptable to HUD.
- 7. Unapproved changes. When there are unapproved changes in the construction, the HUD inspector must modify the amount of the contractor's requisition to cover:
  - a. The non-compliance (any change that has not formally been approved on Form HUD-92437), and
  - b. Construction removal that may be required if the unapproved change does not receive approval.

## **12.10 Change Orders – HUD Architectural and Cost Instructions**

- A. Architectural. The HUD construction analyst will review all requested changes for technical acceptability.
- B. Cost.
  - 1. Construction changes:
    - a. The HUD cost estimator will produce a cost estimate for each construction change request submitted by the mortgagor by applying current data to accepted or amended change order quantities; include amounts for general requirements and builder's overhead and profit using the percentage of each from Section G of Form HUD-92264 that was approved at Firm review.
    - b. Compare the estimate with the mortgagor's estimate and, if reasonable, use the mortgagor's figure. Otherwise use the HUD estimate.
    - c. Complete the cost entries on Form HUD-92437 and forward the completed form to the HUD mortgage credit examiner and/or the appraiser, if applicable.
  - 2. Approved time extensions:
    - a. Calculate the additional general requirements cost due to the extension of time.
      - (1) Divide the cost of general requirements from the contractor's approved Form HUD-2328 by the number of months estimated for construction from Section G of Form HUD-92264 approved at Firm commitment. Sixty-five percent of this amount is the estimate per month of additional general requirements.
      - (2) Use one quarter of the monthly estimate per week.
      - (3) There is no cost effect for extensions of time for less than one week.

- b. Complete the cost entries on Form HUD-92437 and forward the completed form to the HUD appraiser and HUD Underwriter.

## **12.11 Change Orders – HUD Appraisal and Mortgage Credit Instructions**

### **A. Appraisal.**

1. The HUD appraisal staff must review all requested changes that may affect marketability, value, income, or maintenance or operating cost; and identify and explain any estimated increase or decrease in net project income on the reverse of Form HUD-92437.
2. The HUD appraiser must forward a Trial Form HUD-92264 and Trial Form HUD-92264-A reflecting the new data for Mortgage Credit re-determination of the maximum insurable mortgage.

### **B. Mortgage credit.**

#### **1. Processing.**

- a. If the borrower's or contractor's estimate for the change order exceeds HUD's estimate, the difference must be escrowed with the lender. Excess mortgage proceeds, if available, may be used to satisfy this requirement. Conversely, that portion of HUD's estimate which exceeds the borrower's or contractor's estimate must be restricted and held until final endorsement to ensure funds to complete the project.
- b. Process the cost and appraisal findings and show the cumulative effect on cost of all approved change items.
- c. Use Sections 12.8.D and 12.8.E for additive and deductive change orders.
- d. Recalculate the maximum insurable mortgage when any approved construction change or changes adversely affect net income, e.g., a change that causes an increase in project operating costs or a reduction in project income.

(1) The appraiser completes a Trial Form HUD-92264 with an updated income and expense analysis.

(2) Re-determine the maximum insurable mortgage.

(3) If the re-determined mortgage is lower than the original mortgage amount, as a condition of approval of the change order, indicate in item 3b of Form HUD-92437 that subsequent Contractor's Requisitions, Form HUD-92448, must be reduced by the greater of:

(a) The difference in mortgage amounts;

(b) The net increase in costs resulting from acceptable construction changes.

#### **e. Extensions of time.**

(1) Architectural and cost technicians are responsible for determining whether the delay was beyond the contractor's control and, if so, the length of the approved time extension.

(2) Calculate the cost increase due to the extension:

(a) Compute daily rate for interest, taxes and insurance by using estimates in Section G of Form HUD-92264 and multiply these rates by the approved time extension.

(b) An additional year of MIP will be required if the approved time extension, when added to the estimated construction term plus the 2 months included in Section G of Form HUD-92264 plus previously approved time extensions, would extend the term past twelve, twenty four or thirty six months, as applicable.

(c) Add the additional general requirements, if any, noted by the Cost branch on the change order request.

NOTE: Only Item (c) above amends the construction contract price on Form HUD-92437.

(3) Determine the source of funds for any increase due to the extension, e.g. cash, excess mortgage proceeds or non-profit's developer fee, or contingency reserve funds.

(4) Requests for release of excess mortgage proceeds or contingency reserve funds set aside to fund time extensions are submitted on Form HUD-92403.

(5) Releases from a cash deposit are made using Form HUD-92464M.

(6) These funds may be released only after the account for the soft cost item(s) being requested has been exhausted on Form HUD-92451, Financial Record of Mortgage Loan Transaction.

2. Requests for disbursement of contingency reserve funds, working capital construction contingency funds and non-profit's developer fee for completed change order items are made on Form HUD-92403. All requests:

a. Must be accompanied by a certification by the borrower's supervisory Architect and the HUD Inspector that all the work covered by the change order has been acceptably completed in accordance with contract documents.

b. Must include the borrower/borrower's certification relative to payment to the contractor contained on Form HUD-92464M, Request for Approval of Advance of Escrow Funds.

c. Must include the criminal certification contained on Form HUD-92464M for certifications made in paragraphs a and b above.

d. Are subject to a 10 % holdback.

3. Change orders funded from excess mortgage proceeds. Excess mortgage proceeds may be used to fund either necessary or betterment change orders.

a. These funds may be used to fund HUD's estimate of increased costs as well as any portion of the contractor's estimate which exceeds the HUD estimate. The portion which exceeds HUD's estimate must be restricted until final endorsement.

b. Funds are released in the same manner as contingency reserve funds.

4. Releasing Cash Deposit. The borrower must submit, through the lender, Form HUD-92464M when construction covered by a cash deposit is complete and acceptable to HUD.

a. The borrower's supervisory Architect and the HUD inspector must certify on Form HUD-92464M that all work and materials covered by the change order are satisfactory and consistent with contract drawings.

- b. If construction costs were paid in full with other than the cash escrow or excess mortgage proceeds before submitting the disbursement request to HUD for approval, the borrower must submit a receipt of payment signed by the general contractor.
  - c. If construction costs will be paid after HUD's approval for the release of the funds deposited for the construction change, before the next Form HUD-92403 is submitted, the borrower must submit a receipt of payment signed by the general contractor.
5. Change Order Summary Sheet showing cumulative cost of all executed change orders should contain, at least:
- a. The date the change order was signed by the borrower;
  - b. The date HUD received the change order;
  - c. The date the Mortgage Credit branch processed the change order;
  - d. The borrower's or contractor's estimate of cost for the change order;
  - e. HUD's estimate of cost for the change order;
  - f. The amount of change orders to be funded from contingency reserve, working capital construction contingency, non-profit's developer fee, or excess mortgage proceeds;
  - g. The required cash escrow deposit, if any;
  - h. The HUD percentage of cost increase or decrease.

## **12.12 Labor and Fair Housing and Equal Opportunity (FHEO)**

### **A. Wages**

- 1. Payrolls. Contractor payrolls are submitted directly to the HUD Labor Standards and Enforcement staff a minimum of once a month.
- 2. On-site interviews. The HUD Construction Manager forwards all original copies of Form HUD-11, Record of Employee Interview, which are submitted by the HUD inspector to the HUD Labor Standards and Enforcement Staff.

### **B. Labor violations. Advise the Labor Standards and Enforcement Staff of continuing minor infractions that cannot be resolved or of any identified or suspected major violations. Labor standards enforcement staff shall provide written clearance to Housing and OGC in connection with final closing confirming either that there are no outstanding issues and the project may proceed to closing without condition, or that outstanding issues remain and the closing may proceed conditioned on the deposit to the U.S. Treasury of funds sufficient to meet any wage restitution and/or liquidated damages that have been or may be found due. Final closing may not occur without receipt of this written guidance from labor standards enforcement staff.**

### **C. FHEO noncompliance. Advise the local HUD Director of FHEO of continuing minor noncompliance that cannot be resolved or of any identified or suspected major noncompliance.**

## **12.13 Surveys**

Surveys must be by a licensed surveyor and show the exact location of on-site improvements, including utility lines and easements. Please see the FHA Multifamily Program Closing Guide for additional requirements related to survey matters.

- A. The contractor must give the owner and HUD surveys:
  - 1. At any time the owner or HUD requires, and
  - 2. When construction is complete (“as-built” survey).
- B. The inspector, when uncertain of the location of construction or stored materials in relation to property lines or easements, may ask the Architect to require a survey with the next contractor's requisition.
- C. If encroachments are found, the inspector must notify the HUD Construction Manager by memorandum explaining the conditions. (Encroachments may jeopardize the entire property as security for an insured mortgage.)

## **12.14 Permission to Occupy**

Permission to Occupy Form HUD-92485 must be executed by HUD before the borrower permits occupancy of any dwelling unit.

- A. Physical completion. The work, or portion thereof for which Permission to Occupy is approved, must be sufficiently complete in accordance with the contract documents so the mortgagor can occupy or utilize the identified portion of the work for its intended use.
  - 1. Support facilities (utilities, disability access, vehicular access and parking, fire life-safety equipment, etc.) must be in place.
  - 2. The acceptability of each unit and facility for which Permission to Occupy is requested must be confirmed:
    - a. Property must be inspected and Form HUD-92485 signed by the borrower, supervisory Architect, contractor, and HUD Representative.
    - b. Minor items that do not preclude occupancy are permitted but must be listed as an attachment to Form HUD-92485.
    - c. The contractor is fully responsible for any incomplete or improperly performed contract work whether or not listed.
- B. Signatures, Approval and Permission:
  - 1. Form HUD-92485 must be signed by the borrower, supervisory Architect, contractor, lender, and HUD representative.

2. Approval: The Construction Manager or a designated HUD staff person in the Regional Center signs as Chief, Architecture and Engineering Section. The Underwriting Branch Chief signs as Chief Underwriter.
  3. Permission to Occupy: The Regional Center Director and MAP Coordinator will designate an FHA Authorized Agent in the Regional Center or Satellite Office to sign the Permission to Occupy.
- C. Submission Documents. The lender must sign Form HUD-92485 agreeing with the request and stating that insurance risks have been covered for the project. The borrower must include the following documents with the completed Form HUD-92485:
1. A Certificate of Occupancy or equivalent permit from the governing municipal authority for all units and facilities listed on the Permission to Occupy; and any other required permits or authorizations;
  2. An accord or certificate of property and liability insurance from the borrower's insurance company.
- D. Partial Occupancy Approval.
1. Favorably consider partial occupancy of units as they become available, where vandalism could be minimized, needed project income is provided, an earlier rent-up date could be achieved, utility costs for occupied units can be metered separately from contractor's utilities, etc.
  2. Approve a series of Permissions to Occupy as units or facilities become available, e.g. individual buildings on multi-building projects, or individual floors or wings on larger buildings.
  3. Approve a single Permission to Occupy for all units where dictated by management considerations, e.g. very small projects.

## **12.15 Escrowed Funds, Letters of Credit, Deposits, Holdbacks and Related Matters**

### **A. Borrower's Application for Escrowed Funds, for HUD approval.**

Form HUD-92464M, Request for Approval of Advance of Escrow Funds, must be used where the escrow is to ensure completion of offsite improvements, additive change orders, non-critical repairs (under the Section 223(f) program), or borrower's unpaid construction items at final endorsement.

1. The borrower must initiate the process by completing Form HUD-92464M. The lender must complete the Form before submitting the disbursement request to HUD for approval.
2. The HUD inspector is required to record the percentage of acceptably completed escrow work on the HUD Representative's Trip Report, Form HUD-95379. The borrower will review the Trip Report to determine the amount of funds to request for release of escrow funds that align with the completed work. After the borrower has reviewed the Trip Report and entered information on the HUD-92464M, the borrower must forward a copy of both Forms to the lender for their review and completion before the disbursement request is submitted to HUD.
3. HUD will not authorize advances that exceed the documented percentage of completion less previous payments plus a 10% retainage, until work is 50% complete. After the project is 50%

complete reduce the retainage from 10% to 5% up until 75% completion. After 75% completion the retainage may be reduced to 2.5% until the loan reaches Final Endorsement. (This does not apply to Section 223(f) or Section 223(a)(7) loans.)

4. Where excess mortgage proceeds are used to fund an escrow for completion of offsite improvements, additive change orders or mortgagor's unpaid construction items, return the original copy of Form HUD-92464M to the depositor and retain one copy.

B. Release of letters of credit. In the event of a claim:

1. Assignment. HUD will not accept an assignment of the letter of credit to HUD from the lender.
2. Undrawn Balance. HUD will treat any undrawn balance from a letter of credit or escrow agreement as cash held by the lender.
3. Cash equivalent. The lender must provide cash equal to the undrawn balance, if demand on a letter of credit is not met.

C. Working Capital Deposit (HUD-92412M) escrow is established at initial closing with the lender. It is the responsibility of the borrower to advise the lender how it plans to fund the escrow: either by cash, a letter of credit, excess mortgage proceeds, or excess land equity, if any.

1. Purpose. The deposit is used to:
  - a. Defray the cost of initial marketing and rent-up including: sales and advertising, model furnishing, and equipment and supplies essential to initial rent-up, etc.
  - b. Cover project expenses that are not covered by project income or the Initial Operating Deficit Escrow in the first operating year. The project expenses include real estate taxes, permanent property insurance premiums, mortgage insurance premium, ground rents and assessments.
  - c. Cover shortfalls in interest, taxes, property insurance premiums, mortgage insurance premiums, ground rents and assessments during construction after funds available under the Building Loan Agreement are exhausted.
  - d. Fund necessary change orders and construction cost overruns from the 2% new construction contingency portion of the working capital escrow.
2. Control and Release of Escrow. The lender controls disbursements from the escrow except where the borrower certifies at Firm Commitment that any balance of the escrow will be applied to the reserve for replacements or additional betterment change orders on tax credit projects. The lender, in conducting its due diligence during initial occupancy, is required to fully document all expenditures from the escrow. In reviewing a borrower's request to release a partial amount of escrow, the lender should consider the following.
  - a. Borrower's request for the release of such escrow funds must be by letter to the lender, rather than on Form HUD-92403.
  - b. None of the escrow can be used to defray any of the hard costs of construction applicable to the Total for All Improvements, Section G of Form HUD-92264, Rental Housing Project Income Analysis and Appraisal (or other Firm Stage underwriting form applicable to the Section of Act the project is to be insured under).
  - c. Avoid premature disbursements and unnecessary expenditures.

- d. As portions of a project are ready for occupancy, a partial disbursement may be permitted for reasonable opening expenses. However the lender must not exhaust the escrow prior to project completion, but should retain a reasonable amount to offset funding needs through the remainder of the construction period and thereafter.
- e. The Field Office may direct that the deposit be used to cover any shortfall in interest, taxes, property insurance mortgage insurance premiums, ground rent and assessments.

3. Final Release of Escrow.

- a. The lender may release any unused balance in the working capital escrow, subject to HUD approval, to the borrower one year after Final Endorsement where the project is not in default and when the operations of the project have demonstrated to the Regional Center or Satellite Office Director's satisfaction that the project has achieved 6 consecutive months of break-even occupancy. Break-even occupancy is defined as 1.0 debt service coverage, based on all sources of project income including ancillary income.
- b. The lender must hold this escrow until any project financial problems are resolved (e.g., has not reached sustaining occupancy, has insufficient cash to meet project obligations and/ or high payables, is operating at a deficit or is near default).
- c. If the mortgage is in default, the lender must apply any balance of the working capital escrow to cure a default, where a default occurs before its release.
- d. The borrower will receive a refund of any remaining balance of working capital new construction contingency at final endorsement, subject to HUD approval and after any issues discussed in paragraph a, b, and c, above are resolved.

D. Initial Operating Deficit Deposit must be established with the lender at initial closing and is the borrower's responsibility to advise the lender on how it plans to fund the escrow either by cash, a letter of credit, or excess mortgage proceeds, or excess land equity, if any.

- 1. The purpose of the operating deficit escrow is to provide funding for operating expenses and debt service when net income is not available during the initial lease up period. This escrow is not mortgageable and the unused portion must be returned to the borrower.
- 2. Release of the Initial Operating Deficit Escrow. HUD will consider lender's request using Form HUD-92476.a-M, Escrow Agreement for Operating Deficit, for all initial operating deficit draws during lease-up. The lender's request must be accompanied by:
  - a. A review and analysis of the monthly accounting reports detailing progress on lease up as compared to the lease up projections used in underwriting, and
  - b. An updated calculation of the sufficiency of the escrow. This analysis and calculation is particularly important if the project is experiencing substantial variations from its lease up projections.
  - c. Unused amounts will be released upon the lender's request at the later of 12 months after Final Endorsement or when the project has demonstrated to the HUD field office's satisfaction that the project has achieved 6 consecutive months of break-even occupancy. (Break-even occupancy is defined as 1.0 debt service coverage, based on all sources of project income including ancillary income.) The HUD Production Underwriter will consult with Asset Management (AM) staff prior to approval of a release to obtain AM's approval. Regional Centers/ Satellites should exercise caution to be certain that monthly results are not erratic or

seasonal and that 1.0 or better debt service coverage will be sustainable after release of the escrow funds. For garden apartment projects consisting of separate buildings, each of which is leased up separately, HUD will consider partial releases of the operating deficit escrow as individual buildings achieve 6 consecutive months of break-even occupancy. It is the lender's responsibility to fully document all expenditures from the escrow fund to ensure that funds are used solely for project operating needs.

- E. Amount of contractor's retainage and release. The retainage provides an incentive for the general contractor and mortgagor to promptly complete the project, submit cost certification and reach final closing.
1. Amount of retainage. The Building Loan Agreement allows for the possibility of a reduced holdback (10%) amount as set forth in a retainage reduction rider when the project reaches 50% completion. The rider is not a HUD form. The owner and the general contractor will create a rider, to attach to the Building Loan Agreement, which describes how the retainage is reduced according to the guidance below. The construction contract also provides for a 10% holdback from the contractor's monthly payments for acceptably completed work, acceptably stored materials, and where applicable, components acceptably stored offsite. The requirements for reduction of the retainage after 50% completion are as follows:
    - a. The Contractor has no identity-of-interest with the owner that is greater than a 5% equity interest in the ownership entity,
    - b. Prior written consent from the Surety must be obtained and attached to the request for reduction, and
    - c. There can be no questions regarding the contractor's performance concerning the quality of work, compliance with the contract and with any change orders or work in progress. The Regional Center or Satellite Director must make the decision to reduce the retainage based on the recommendation of HUD's construction inspector.
    - d. Assuming the above conditions are met, and subject to HUD approval, the existing standard of 10% retainage will be required only until 50% completion. After 50% completion the retainage may be reduced from 10% to 5% until 75% completion, and then may be reduced further to 2.5% retainage until the loan reaches Final Endorsement.
  2. Release of retainage for identity of interest contractors. Except as provided in paragraphs 4 and 5 below, the retainage may not be released, in whole or in part, until Final Endorsement for a contractor with an identity of interest.
  3. Release of retainage for non-identity of interest contractor. The contractor's retainage, or the remaining balance in the retainage, may be released at the next to last advance, when requisitioned on Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds, and subject to compliance with the following:
    - a. Contractor's cost certification, where required, has been reviewed and necessary adjustments made to Form HUD-92451, Financial Record and Mortgage Loan Transaction;

- b. Contractor has disclosed its final obligations on Form HUD-92023M, Request for Final Endorsement of the Credit Instrument;
  - c. All work under the construction contract has been inspected and approved by the controlling jurisdictions and/or authorities;
  - d. Certificates of occupancy or other required approvals for the dwelling units and non-dwelling facilities, where applicable, have been issued by governmental authorities having jurisdiction. (Separate buildings for community rooms, rental offices, laundry rooms, etc., commonly require separate certificates of occupancy.);
  - e. Permission To Occupy, Form HUD-92485 has been issued by HUD for all units;
  - f. All Davis-Bacon payroll requirements have been satisfied;
  - g. Surveyor's Certificate, Form HUD-91073M, and survey showing the location of all improvements, utility easements and site utility distribution lines have been submitted to HUD, and
  - h. Retain, where applicable, an adequate amount to cover the following:
    - (1) Items of delayed completion in an amount equal to 150% of the HUD representative's cost estimate for completion,
    - (2) Any owed or contested amounts indicated by mechanics, subcontractor, supplier, or equipment lessor liens, etc.
    - (3) The lesser of the liquidated damages or actual damages computed at cost certification, and
    - (4) The net effect of any negative change orders.
4. Early partial release of retainage.
- a. After 90% contract completion, the Regional Center Director may release part of the general contractor's retainage and suspend further withholding of retainage from payments due, where:
    - (1) The contractor has no identity of interest or the contractor's only identity of interest in the project ownership is less than 5%;
    - (2) The contractor, mortgagor and mortgagee request the early release of the holdback and attach the request to Form HUD-92403, Application for Insurance of Advance of Mortgage Proceeds; and
    - (3) Prior written consent from the surety, if any, for the early release of holdback is provided with the request.
  - b. The Regional Center Director determines that:
    - (1) The contractor's general performance warrants partial release of the holdback without conditions, or
    - (2) A partial release of the holdback is appropriate with conditions, e.g., measures to assure immediate distributions to subcontractors or others, would be in the mutual interest of all participants, and
  - c. The undisbursed holdback amount must equal or exceed 5% of the contract amount.

5. Projects in difficulty. Release of part of the contractor's holdback before 90% contract completion may be granted only to prevent a default of the construction loan and only if it would solve the project's problems and enable it to reach construction completion.
    - a. The contractor's performance must be considered, including:
      - (1) The completed work must be satisfactory,
      - (2) The percentage of completed contract work must be sufficient to ensure project completion within the specified contract time, and
      - (3) The holdback may not be released if there are, unresolved questions concerning:
        - (a) Quality of work,
        - (b) Compliance with the contract, including outstanding change orders, or
        - (c) Work is progressing behind the contractor's construction schedule, as amended by approved change orders.
    - b. Written consent for the early release of holdback must be obtained from the surety, if any, the mortgagor and the mortgagee.
- F. Cash-Out Escrow From Land Equity or (any balance remaining after capitalizing the escrow.) See Section 8.14.K.
1. Cash out from the excess value of the land, or the “as is” property value for a substantial rehabilitation project, that was contributed to meet the sponsor’s equity requirement at initial endorsement, **above** what was required at initial endorsement must be deferred and held by the lender. If any of the land equity was used to fund escrows at initial endorsement, the remaining balance is deferred and held by the lender. The lender will have discretion as to the form of escrow to use to hold back any cash-out from land equity. Refer to Appendix 12A paragraph E about eligible uses of equity before the escrow is held by the lender.
  2. The lender will hold the cash out funds until project operations have demonstrated to the HUD field office’s satisfaction that it has achieved 6 consecutive months of break-even occupancy or 12 months break-even occupancy for transactions that meet the Large Loan parameters. (Break-even occupancy is defined as 1.0 debt service coverage, based on all sources of project income including ancillary income.) HUD Production Underwriter will consult with AM staff prior to approval of a release to obtain AM’s approve of the release. Multifamily Regional Center/Satellite should exercise caution to be certain that monthly results are not erratic or seasonal and that 1.0 or better debt service coverage will be sustainable after release of the escrow funds. HUD will approve a request for release of funds on Form HUD-92464M from the lender. The lender’s file should contain the HUD approval and documentation supporting the release.

## 12.16 Insurance Upon Completion

- A. Basic requirements during construction stage are generally the same as for projects with insured advances. However, because HUD does not insure advances for the construction loan, HUD does not

monitor the lender's disbursements. Additionally, because HUD has no risk exposure until final endorsement, HUD does not become involved in the workout of construction problems. The following are major variations from standard program requirements for insurance upon completion projects.

- B. Firm Commitment to Insure upon Completion, Forms FHA-2453, FHA-2453-MM (for Section 223(f)), must be valid and outstanding until Final Endorsement of the permanent mortgage.
  - 1. No initial closing. The construction stage starts after the issuance of the Firm Commitment.
  - 2. Construction/rehabilitation must start and be completed within the period provided by the Firm Commitment.
  - 3. Extensions. See Chapter 11 for the extension of:
    - a. Construction period;
    - b. Firm Commitment expiration date, where required to permit project completion and Final Endorsement.
- C. Required documents include:
  - 1. Construction contract, Form HUD-92442M. The following must be made a part of the contract:
    - a. General Conditions, AIA Document A201;
    - b. Supplementary General Conditions, Form HUD-92554M;
    - c. Davis-Bacon Wage Rates (supplied by HUD Labor Standards and Enforcement);
    - d. HUD Amendment to the B108, Owner-Architect Agreement to Identify Identities of Interest between Owner/Contractor/Subcontractor/Architect;
    - e. Cost certification criteria from Form HUD-92442M, Article 13, where an identity of interest exists or a "cost plus" form of contract is used.
  - 2. A complete master set of drawings and specifications and two duplicate sets;
  - 3. The Agreement and Certification, Form HUD-93305M, executed by the mortgagor, lender, and HUD.
  - 4. A title policy or title evidence showing:
    - a. Insured property free of all encumbrances other than the mortgage and acceptable reservations of title;
    - b. Proof that no unpaid obligations exist except as previously approved by HUD;
    - c. Title policy continued to date of credit instrument endorsement.
  - 5. Survey and Surveyor's Certificate, Form HUD-91073-M;
  - 6. Contractor's Requisition Project Mortgages, Form HUD-92448. The Contractor's Prevailing Wage Certificate must be submitted at the time the mortgage is presented to HUD for insurance.
  - 7. Assurance of funds to meet operating deficit. Completed Forms to assure funds are available to carry the project to a sustaining occupancy after final closing:
    - a. HUD-92476M, Agreement of Sponsor to Furnish Additional Funds,
    - b. HUD-92476a-M, Escrow Agreement for Operating Deficit, and
    - c. HUD-92477M, Bond Guaranteeing Sponsor's Performance.

8. Assurance of completion: Not applicable to insurance upon completion projects.
  9. Warranty against latent defects is required in accordance with Section 12.16.S.
- D. The pre-construction conference must precede the initial start of construction, see Section 12.2.
- E. Construction monitoring and reporting must be done in accordance with Section 12.3.
- F. Labor and FHEO liaison, see Section 12.12.
- G. Contractor's monthly requisitions are not applicable to projects insured upon completion.
- H. Offsite construction:
1. Monitoring is recorded by the HUD inspector on Form HUD-95379.
  2. Advance of funds monitoring is not applicable to projects insured upon completion.
- I. Construction contract changes and Architect's supplemental instructions (see Sections 12.8 to 12.11 and 12.4.D). Construction changes are processed in the same manner as insurance of advances, except as modified below:
1. An escrow is not required for additive change orders, because HUD has no risk exposure until final closing. The mortgagor must be able to provide the additional funds required and must not have any outstanding obligation in connection with construction other than the insured mortgage at the time the mortgage is presented for insurance.
  2. Surety approval is not required for the approval of additive change orders regardless of the percentage of contract increase.
- J. Permission to Occupy applies as in Section 12.14.
- K. Final HUD representative's Trip Report falls under HUD procedures.
- L. Guarantee period falls under HUD procedures.
- M. Working capital deposit and operating deficit escrows are not usually required for Insurance upon Completion projects. However, to mitigate any risk, projects that apply for Insurance upon Completion must fully meet the operating deficit escrow and the working capital requirements contained in Section 8.13, except for the extra 2% new construction contingency portion of the working capital escrow which is not required. See Sections 12.15.C and 12.15.E for releasing escrowed funds.
- N. Property insurance schedule and requirements. When onsite construction is 80% complete (before Final Endorsement of the mortgage), the lender must prepare:
1. Property Insurance Schedule, Form HUD-92329, that:
    - a. Correctly shows the insurable value of the completed structures;
    - b. Reflects any changes in cost occurring after issuance of Firm Commitment.
  2. Property Insurance Requirements, Form HUD-92447.

- O. MIP is not charged until the project reaches final closing.
- P. Cost certification (see Chapter 13).
- Q. Closing must occur within the period provided in the commitment.
- R. Extension of Firm Commitment instructions are in Chapter 11.
- S. Builder's warranty. The general contractor must enter into a latent defect agreement with the Owner and Lender for the benefit of HUD and provide one of the following at Final Endorsement to assure correction of any latent defects:
  1. Cash escrow deposit of 2.5% of the principal amount of the mortgage, to be retained in escrow by the lender for a period of 15 months, or
  2. An irrevocable, unconditional letter of credit issued to lender by a banking institution, or
  3. Surety bond in the amount of 10% of the cost of construction or substantial rehabilitation. The bond must be in effect for 2 years after substantial project completion. The bond must be on Form HUD-3259, Surety Bond Against Defects Due to Defective Materials and/or Workmanship.
  4. In cases when the latent defect escrow amount is small because total repair cost is minimal (e.g., \$200,000 or less), the escrow is not required. The HUD Regional Center has the discretion to waive the latent defect escrow.

## **12.17 Completion of Repairs Pursuant to Section 223(f)**

- A. Required Repairs are to be documented by the lender with a list that categorizes repairs as critical repairs or non-critical repairs. (See Section 5.10.L. and Appendix 5H).
  1. Critical repairs are any individual or combination of repairs required to correct conditions that:
    - a. Endanger the safety or well-being of residents, visitors or passers-by;
    - b. Endanger the physical security of the property;
    - c. Adversely affect project or unit(s) ingress or egress; or
    - d. Prevent the project from reaching sustaining occupancy.
  2. Non-critical repairs consist of all repairs other than critical repairs. .
  3. Completion of repairs.
    - a. Before closing: Critical repairs must be completed before Initial closing. A site visit(s) and report(s) by a HUD representative are required to confirm satisfactory completion of required repairs before closing unless HUD waives or delegates the responsibility.
    - b. After closing: At the request of the mortgagor, only non-critical repairs may be completed after closing. HUD will require the following schedules:
      - (1) Schedule of Values for payment of completed repairs;
      - (2) Progress Schedule. All repairs must be completed within 12 months of loan closing;

(3) Schedule of Delayed or Interrupted Occupancy or Income, must list:

- (a) All facilities for which occupancy or income will be delayed or interrupted by repairs delayed until after closing;
- (b) Period of delayed or interrupted occupancy or income;
- (c) Projected completion date.

(4) Release of Cash-Out/ Equity from Loan Proceeds.

Projects with a 50% cash-out holdback escrow set up at Initial/ Final Endorsement on Form HUD-92476.1M, Escrow Agreement for Non-Critical, Deferred Repairs, are released at the request of the Lender when the non-critical repairs are complete within 12 months of the Initial/Final Endorsement. The owner may request through the Lender a release of escrow funds during the progress of completion of the repairs, subject to evidence that the property title is free and clear of mechanics liens, and that latent defects assurance is in place and has been submitted to HUD. The owner must have demonstrated the ability to complete repairs in a timely manner (repair progress schedule), and a commitment to keeping the property in good repair with no deferred maintenance.

4. Payment for Repairs.

- a. Critical Repairs completed before closing: Mortgage proceeds may be advanced at Initial/Final Endorsement upon verification that repairs have been completed.
- b. Non-Critical Repairs completed after closing established by a repair escrow:
  - (1) A completion repair escrow account must be established and held by lender in an amount equal to 110% or 120% of the estimated repair costs (see Section 5.10.L) depending upon program guidance.
  - (2) The Schedule of Values for completed repairs will be provided to the HUD inspector, who will recommend progress payments from this Schedule as a part of the Trip Report, Form HUD-95379.

B. Unless HUD waives or delegates this inspection responsibility to others, an inspection of completed repairs is performed by the HUD Inspector. It is anticipated that projects insured under Section 223(f) with Level 1 Alterations (as defined in Chapter 5 of the MAP Guide) will not require inspections. Those projects with Level 2 Alterations may require inspections based upon the type and complexity of improvements, as may be determined by the CM. Those projects with Level 3 Alterations will require inspections at repair completion stages of 35%, 65% and 100%. Inspections may be attended by the owner, the architect, builder, consultants, and any other necessary parties. The inspection showing that all repairs covered by the repair escrow are completed shall be considered the final inspection.

- 1. Inspection Reports are filed on Form HUD-95379, HUD Representative's Trip Report, for each monitoring visit. The following are included in the Trip Report:
  - a. Non-compliance with provisions of the commitment or closing, e.g. work write-up, drawings, specifications, etc., including changes made to the work without prior approval;

- b. Adverse conditions e.g. slow work completion, destruction of work, new municipal requirements, disputes, etc.
  - c. Availability for use of facilities listed on the schedule of delayed or interrupted occupancy.
  - d. Municipal authorizations. Permissions to occupy use permits, etc. Where applicable, these must be issued before closing, unless related to work delayed until after closing;
  - e. Items to be completed within twelve months from initial/final endorsement. The HUD inspector must include:
    - (1) A detailed list of any exterior work;
    - (2) Recommended escrow amount; and
    - (3) Recommended completion date (not later than 12 months after closing);
2. Assignment documents. The MAP Lender and HUD should assemble the following documents to monitor repairs and recommend payments:
- a. Firm Commitment;
  - b. Escrow agreement (where closing has occurred);
  - c. Survey, surveyor's report and legal description;
  - d. List of required repairs (work write-up with clear and accurate scope cost and schedule of the work items);
  - e. Drawings and specifications (where required);
  - f. Schedule of Values (required only for projects with repairs delayed after closing);
  - g. Progress schedule (required only for projects with repairs delayed after closing);
  - h. Schedule of delayed or interrupted occupancy or income (required only for projects with repairs delayed after closing); and
  - i. Agreement and Certification.
- C. Repair completion. All work must be acceptably completed before the loan closing, except for the following:
- 1. Minor exterior work, which cannot be completed because of weather conditions, may be completed after closing, on projects for which prior provisions were not made for completion of non-critical work after closing; include the amount (s) to be escrowed.
  - 2. Non-critical repairs may be completed after closing when provided in the commitment and when a completion escrow is established at closing, except that:
    - a. All critical repairs must be completed before closing; and
    - b. An additional deposit must be made to an operating deficit account for delayed repairs which will delay or interrupt occupancy or income for any period. The amount of the additional deposit will be determined by HUD.
  - 3. Repair monitoring. All work must be monitored and be acceptable to the lender and HUD whether it is performed before or after closing.

- D. Final report must be made upon completion of all work and is to be prepared by the HUD Inspector or the Architect as may be determined by HUD. The final report must show that:
1. All work is acceptably completed in accordance with the firm commitment and/or closing escrow, as applicable, and approved changes;
  2. Offsite work is completed or that the municipality has given written assurance for its completion;
  3. Utilities are connected;
  4. Permanent ingress and egress facilities are provided, and
  5. Applicable municipal inspections, approvals, etc., have been issued.
- E. Changes in the repair work, including associated cost changes, must be submitted by letter or other acceptable format i.e. sending a letter via electronic mail. Form HUD-92437 may be used as a general guide, but the actual form must not be used.
1. Borrower and Lender must review and sign the modified list of required repairs describing all changes before submitting to HUD for review;
  2. Contractor and borrower's Architect, if employed, must sign all changes.
- F. Guarantee inspections. Where the owner uses a contractor, rather than its own staff, to carry out repairs, guarantee inspections will be scheduled to discover and require correction of latent defects within 1 year of the date of substantial completion of all repairs. See Sections 12.6.C and 12.16.C.
- G. Projects in difficulty. Physical, financial, or management problems could be an indication that a default is imminent. For further explanation see Management Agent Handbook 4381.5 REV-2 Chapter 6 Exhibit 6-1.
1. If the borrower has not completed all deferred repairs by the end of the repair period the HUD Inspector will document all such non-completed repairs on Form HUD-95379, HUD Representative's Trip Report, and will submit the report to the lender with a copy to the HUD Construction Manager.
  2. The lender will complete the repairs using the repair escrow funds. The lender will submit a work schedule to HUD for the completion of all remaining repairs, and will provide the borrower with a breakdown of these repairs and the cost(s) of completion (including administrative expenses).
  3. Funds remaining in the repair escrow account after completion of the repair work by lender will be returned to the borrower, less reasonable administrative costs incurred by lender in completing the repairs.

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## Chapter 13 Cost Certification

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### 13.1 Projects that Must Certify

Cost certification is required for all insured multifamily projects, except when the mortgage is 80 percent or less of value and at least one of the following two criteria applies: the transaction involves tax credits, or the project is refinancing under Section 207/223(f).

### 13.2 Purpose of Certification

The purpose of certification is to establish the borrower's actual costs, including contractor's cost, and establish the "maximum insurable mortgage" for Final Endorsement of the insured mortgage.

### 13.3 Certifiable Costs

Certifiable costs are those costs that have been paid in cash or will be paid in cash within 45 days of final closing, except for:

- A. Land Value which HUD will calculate,
- B. General Overhead which is certifiable whether or not it is paid in cash,
- C. BSPRA, which is cost certifiable whether or not it is paid in cash, where there is an identity of interest between the borrower and contractor, and
- D. Non-profit Developer's Fee, which is cost certifiable whether or not it is paid in cash, less amounts certified to and allowed on other line items.

### 13.4 Projects with LIHTCs are Exempt from Cost Certification Requirements

The Housing Economic Recovery Act (HERA) of 2008 affected the borrower's obligation to certify "actual cost" (as defined in the National Housing Act) under the insured mortgage programs. If it is determined at the time of issuance of the Firm Commitment for insurance that the ratio of loan proceeds to the actual cost of the project is less than or equal to 80 percent, the borrower is not required to certify

actual cost to HUD. The exemption affects construction, rehabilitation (including property acquisition), purchase or refinance of a multifamily housing project for which equity is provided through tax credits, i.e. LIHTC, Historic Tax Credits or New Market Tax Credits. Since the actual cost is not known at the time of the issuance of the Firm Commitment use, in lieu of actual cost to determine the exemption from cost certification, the *Total Estimated Replacement Cost* of the project (see Section G, line 74 on the Form HUD-92264). An example of this computation is below.

Note that the borrower and the general contractor have the option to cost certify according to the guidance in Sections 13.6 through 13.19.

A. This example illustrates the applicability of the cost certification exemption for a new construction and substantial rehabilitation project using the lowest controlling mortgage criterion.

Total Project Replacement Cost (Section G line 74 Form HUD-92264) .....	\$ 13,000,000
Tax Credit Equity for Mortgageable Items (Form HUD-92264-A) .....	\$ <u>5,000,000</u>
Maximum Insurable Mortgage Amount (Form HUD-92264-A) .....	\$ 8,000,000
$\$ 8,000,000 / \$13,000,000 = 62\%$	

B. Audit Fee

In cases that are exempt from cost certification, a Cost Certification Audit Fee, Section G line 66, on Form HUD-92264 is not applicable. The borrower and the general contractor may certify to their actual costs. Should they decide to cost certify per HUD’s methodology, the audit cost is mortgageable.

C. Substantial Completion Date

1. The substantial completion date is the date the Architect dates and signs the certification on Form HUD-92485, Permission to Occupy Project Mortgages (PTO). Upon execution, the Architect certifies that the construction work is sufficiently complete in accordance with the construction contract documents such that the project may be occupied for the intended use except for acceptable items of delayed construction completion. The HUD inspector will complete the portion, “FHA Inspection Report” on the Form to verify that construction is substantially complete and the project is suitable for occupancy. The Form is subsequently signed by HUD’s Authorized Agent granting approval of the PTO. Upon execution of the PTO the HUD inspector must prepare, date and sign the final Form HUD-95379, HUD Representative’s Trip Report documenting the project has reached 100% substantial completion. The Regional Center or Satellite Office will notify the borrower, general contractor, and lender, in writing of the substantial completion date so that preparation for final closing can begin.

To account for multiple buildings constructed under one insured mortgage the Architect will approve a series of Permissions to Occupy as buildings are complete and units become available. When all buildings are complete the Architect will write on the front of the HUD-92485 indicating it is the final PTO.

2. The final trip report will mark when project operations begin. In the absence of a cost certification cut-off date, the Production staff will enter “The Date of Visit” from the final HUD-95379 as the cost cut-off date in the HUD data system (i.e. DAP (Development Application Process)) and advise the borrower of the date. The day after that date becomes the “Financial Assessment Subsystem (FASS) date” to start project operations and begin annual financial statement (AFS) reporting.

#### D. Treatment of Operating Income Generated During Construction

1. The borrower must account for all operating income generated during construction and ending three months before the originally scheduled date of the first principal payment under the mortgage. In cases such as new construction with partial occupancy approval as described in Section 12.14.D or a substantial rehabilitation tax credit project, without significant resident displacement, there may be considerable net operating income (NOI) (or interim income) generated during the construction period. This interim income may be used to pay for mortgageable and non-mortgageable items. Therefore, the borrower must prepare an Operating (or Income and Expense) Statement covering the period from first occupancy (if occupancy occurred during construction see Section 12.14.D) or from the date of substantial completion through the period ending three months before the date of the first principal payment of the originally scheduled mortgage. The borrower may include in the operating statement all soft costs incurred up to 60 days beyond this date, which will establish the cut-off date. The day after the cut-off date becomes the FASS and operations reporting date. The Lender must submit the borrower’s operating statement to HUD at least 30 days before the final endorsement scheduled date. If the operating statement evidences receipt of NOI during this period, the borrower can apply the interim income according to the following:
  - a. If the replacement cost mortgage (Criterion 3) is not the controlling mortgage, any NOI generated during construction may be applied to cover shortfalls in mortgageable soft costs, change orders, initial operating deficit and escrows. At final endorsement the balance of funds may be distributed to the borrower or deposited to the project’s Reserve for Replacement account or applied toward the amortization of the mortgage principal.
  - b. If the replacement cost mortgage (Criterion 3) is controlling the Mortgage Credit staff will do a calculation and determine if the interim NOI is equal to or greater than 1% of the original mortgage, and if it is, calculated interim NOI is deducted from the certified replacement cost amount. When the NOI does not meet this 1% threshold, apply the amount toward shortfalls, etc. as instructed in number 1 above. The Lender must deposit any remaining balance into the project’s Reserve for Replacement account or applied toward the amortization of the mortgage principal at final endorsement. There is no distribution to the borrower.
  - c. See Section 13.19.C below on the distribution prohibition for a borrower’s affiliate or principal.

2. In those cases whereby interim income is not generated or the borrower opts not to set a cost cut-off date, it is not necessary for a borrower to submit an operating statement. The Regional Center or Satellite Office will notify the lender, borrower, and general contractor, in writing, of the 100% final completion date from the final Form HUD-95379, HUD Representative's Trip Report. The Production staff will entered "The Date of Visit" from the final HUD-95379 as the cost cut-off date, into the HUD data system. The day after this date will be considered the start of project operations and FASS reporting.

E. Copy of Final Sources and Uses Statement. The lender may submit a copy of the final Sources and Uses Statement prepared by the state tax credit allocating agency to assist in the lender and HUD review of the final amounts of sources, income and uses.

F. Modification to Form HUD-92580 – Determination of Maximum Insurable Mortgage

For those projects that are exempt from providing a cost certification, after substantial completion, the Regional Center or Satellite OFFICE will issue a modified Form HUD-92580, as illustrated below. Strikeouts are illustrated on line items 2 and 10, below:

- 1. (a) Original Mortgage Amount ..... \$10,000,000.00  
 (b thru e) are not applicable - *Insert N/A or cross through.*
- 2. ~~Certified Actual Cost~~ – *Strike certified actual cost and Insert*  
*Replacement Cost From Section G Line 74* ..... \$13,000,000
- 3. Disallowed Cost ..... *(Insert N/A)*..... \$ N/A
- 4. Recognized Actual Cost of Improvements ... (Sec. G Line 74) ..... \$13,000,000
- 5. Land ..... \$\_\_\_\_\_
- 6. TOTAL LAND AND IMPROVEMENTS ..... \$13,000,000
- 7. Statutory Percentage of Total Cost (\_\_\_\_ % of item 6) ..... \$ N/A
- 8. For Substantial Rehabilitation-Property Owned, enter the Lesser of:
  - (i) \$\_\_\_\_existing Mortgage Indebtedness on (Land and Improvements to be Rehabilitated) or
  - (ii) An Amount Equal To \_\_\_\_% of the Fair Market Value \$\_\_\_\_ of Land and Improvements
 Before (Repair or Rehabilitation) ..... \$ N/A
- 9. TOTAL Line 7 plus line 8, (if any) ..... \$ N/A

10. Maximum Insurable Mortgage in Multiples of \$100, (Item 1(a)) or

Item 6 whichever is the Lesser) .....\$10,000,000

**NOTE:** The Mortgage Credit staff should note on this Form that the project is exempt from cost certification due to the *loan proceeds* to actual cost being less than 80%. Insert the actual percentage of the loan to cost \_\_\_\_\_.

Completion of the reverse side of the Form as follows:

Schedule 1 N/A

Schedule 2 Disallowed Costs: N/A

Schedule 3 Computation of Borrower's Initial Equity Investment

1. Total Land and Improvements (line 6 above)	<u>\$13,000,000</u>
2. Less: Maximum Insurable Mortgage (line 10 above)	<u>\$10,000,000</u>
3. Borrower's Initial Equity Investment	<u>\$ 3,000,000</u>

### 13.5 Types of Cost Certification

- A. Standard or "Long Form" Certification is required, except for projects permitted to use the "simplified" cost certification and for certification of projects insured under Section 207.
- B. Simplified Certification is restricted to projects involving 40 units or less of proposed construction or substantial rehabilitation and is used for projects under Section 207/223(f).
- C. Section 223(f) Certification is required for all projects insured under Section 207 except in cases for Section 207/223(f) transactions where the insured mortgage is 80% or less of the value.
- D. Section 223(f) Supplemental Certification is required for projects identified in paragraph C above, when completion of repairs is permitted after closing. The Certification is submitted 15 business days after repairs are confirmed complete.

### 13.6 Entities That Must Cost Certify

- A. The borrower must certify under all programs, **except** where HUD has determined at the time of issuance of the Firm Commitment that the insured mortgage under: a) Section 221(d)/220/231 new construction/substantial rehabilitation is 80% or less of replacement cost **and** the project is will benefit from LIHTC, Historic Tax Credits or New Market Tax Credits, or b) Section 207/223(f) refinance is 80% or less of value..

- B. When the borrower is required to cost certify, the Contractor must also cost certify when:
  - 1. The Contractor has an identity of interest with the mortgagor, whether such identity of interest existed or developed before or after the initial closing (for insured advances projects) or issuance of the Firm Commitment (for insurance upon completion projects); and/or
  - 2. The Contractor used the Construction Contract-Cost Plus, Form HUD-92442M, whether or not any identity of interest with the borrower existed or developed.
- C. When the Borrower is required to cost certify the subcontractors at any tier, equipment lessors, material suppliers and manufacturers of industrialized housing must cost certify where:
  - 1. The total of all subcontracts, purchases, and leases are more than 0.5% of the mortgage, and
  - 2. An identity of interest exists or comes into being between such subcontractor, equipment lessor, material supplier, or manufacturer of industrialized housing and either:
    - a. The borrower; or
    - b. The contractor, where the contractor must cost certify.

### **13.7 Cost Certification Sequence of Events**

- A. Notification of Pre-Cost Certification Conference. HUD must notify the lender, borrower, and contractor when the project is 80% complete. HUD should notify new sponsors and general contractors as early as 70% completion. The letter should state that:
  - 1. The borrower, general contractor, their accountants, and the lender should attend the conference.
  - 2. Enclose with the letter the (800) 767-7468 number or the internet address for:
    - a. Handbook IG 2000.4 Consolidated Audit Guide for HUD Programs: [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/handbooks/oigh/2000.4](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/handbooks/oigh/2000.4)
    - b. Four copies of each of the applicable forms: ([http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/administration/hudclips/forms/hud9#group2](http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/forms/hud9#group2)):
      - (1) Form HUD-92330, Borrower's Certificate of Actual Cost.
      - (2) Form HUD-92330A, Contractor's Certificate of Actual Cost, if applicable.
- B. Conduct of conference is the responsibility of the assigned HUD staff and should be held before the project is 90% complete. At the conference, HUD staff will explain:
  - 1. Substantial completion, administrative completion, and cut off dates.
  - 2. Documentation required for cost certification including the income statement and balance sheet.

3. Remind the borrower and accountant that they are responsible for computing the liquidated damages/actual damages and incentive portions, if applicable, of the construction contract using the certified amounts on Form HUD-92330.
  4. Necessity for a careful review and completeness of the documentation including dates and signatures, and timeliness of the submission, HUD review, and final endorsement.
  5. Any problems with prevailing wage certifications or other labor issues.
- C. Cut-off date established for computation of the cost certification. Submission and HUD approval of the cost certification must occur before final closing, except that the Section 223(f) supplemental cost certification is not required until completion of non-critical repairs deferred until after closing.
- D. Upon completion of the project, Form HUD-92464M, Request for Approval of Advance of Escrow Funds, should be prepared by the lender and submitted to HUD for approval.

### **13.8 Substantial Completion Date, Cut-Off Date, and Final Completion Date**

#### A. Completion dates.

1. The substantial completion date for determining actual costs is the date the Architect dates and signs the certification on Form HUD-92485, Permission to Occupy Project Mortgages. The Architect is certifying that part of or all of the construction work is sufficiently complete in accordance with the construction contract documents and that the project may be occupied for the intended use. The form is subsequently signed by HUD's Authorized Agent. Construction must be complete except for acceptable items of delayed completion and the Regional Center or Satellite Office will notify the borrower, general contractor, and lender, in writing, of the substantial completion date.
2. The substantial completion date is the effective date for cost certification. The borrower has the option to include in the cost certification all soft costs incurred up to 60 days beyond this date. The date selected by the borrower is the "cut-off date" for the soft costs.
3. The borrower's balance sheet and operating statement date must agree with the selected cut-off date.
4. The final completion is the date the HUD Inspector signs the final HUD Representative's Trip Report, Form HUD-95379, provided that the Construction Manager subsequently endorses the trip report. Construction must be 100% complete.
5. For financial reporting purposes, the day after the cut-off date is the commencement of operations and the projects' first year of reporting annual audited financial statements. This first year will cover the period from the day after the cut-off date to the projects' fiscal year end. This is the date Asset Management will start monitoring the project's financial condition (monthly accounting reports) once the certificates of occupancy (Form HUD-92485) are issued.

## 13.9 Administrative Completion Date

The Regional Center Director may advance the completion date to prevent unnecessary accumulation of soft costs when projects which are nearly complete face unnecessary delay.

- A. The Regional Center Director may set an administrative completion date for any project when the monthly inspection reports show 95% completion of work and thereafter less than 2% increase in percentage of completion in any month.
- B. The Regional Center Director will notify the borrower, general contractor, and lender in writing of the administrative completion date and the following:
  - 1. The administrative completion date is the effective date for cost certification except that all soft costs up to 60 days beyond this date may be included at the option of the borrower.
  - 2. The date of the balance sheet and operating statement must be the same as the cut-off date selected by the borrower.
  - 3. Liquidated/actual damages for cost certification purposes will be computed using the administrative completion date. However, the general contractor is responsible for liquidated/actual damages through the date of substantial completion.
- C. Copies of the notification go to the HQ Docket, Office Docket and Closing Attorney's file.

## 13.10 Submission Date

The submission date for cost certification should be within 30 to 45 days after the cut-off date, and not less than 30 days before the desired final closing date.

## 13.11 Required Forms

- A. Form HUD-92330, Mortgagor's Certificate of Actual Cost; see line-by-line instructions contained in the Forms Book or on the multifamily internet site:  
<http://www.hud.gov/offices/adm/hudclips/handbooks/hsg/4470.2/index.cfm>.
- B. Form HUD-92330A, Contractor's Certificate of Actual Cost; see instructions contained herein at Sections 13.12, 13.16, and 13.17. The subcontractor, material supplier, industrialized housing manufacturer, and the equipment lessor are required to use this form to certify cost.

**NOTE:** When a project includes rehabilitation and new construction, a separate form is required for each, with a master form summarizing total project costs, including fees.

- C. Form HUD-2205-A, Borrower's Certificate of Actual Cost (Section 207 Pursuant to Section 223(f)), and line by line instructions are contained in the Forms Book or on the multifamily internet site <http://www.hud.gov/offices/adm/hudclips/index.cfm>.

## 13.12 Required Statements and Certifications

For all projects, regardless of whether the project has a cost certification exemption, the required statements and certifications are:

New construction - an unaudited balance sheet that covers the period from the date of initial endorsement through cut-off and an unaudited income statement that covers the period from the date of initial occupancy through the cut-off date. The format and content of the balance sheet must follow Section 13.12.B.4 & B.5, below.

Substantial rehabilitation – an unaudited balance sheet and an unaudited income statement that is dated from the date of initial endorsement through the cut-off date. The format and content of the balance sheet must follow Section 13.12.B.4 & B.5, below.

Follow either A or B, below, depending on qualifications in A.1.

A. Simplified Form of Cost Certification. Use Forms HUD-92330, HUD-92330A (if a cost plus construction contract was used or an identity of interest exists between the borrower and the general contractor). An accountant's opinion is not needed.

1. Simplified cost certification is permitted for new construction or substantial rehabilitation project's involving 40 units or less and for refinancing or purchase of existing properties under 207/223(f).
2. If there is an identity of interest between a subcontractor, material supplier, equipment lessor, or manufacturer of industrialized housing and the borrower and/or general contractor must cost certify, and the total of all identity of interest subcontracts, purchases and leases is more than 0.5% of the mortgage, the identified party uses Form HUD-92330A. This requirement established by the Agreement and Certification, Form HUD-93305M, applies in all cases.
3. An un-audited balance sheet of the borrower entity, as of the cut-off date is required in all cases. Format and content of the balance sheet must follow Section 13.12.B.4, below.
4. An un-audited operating statement is required if occupancy occurred during construction. Format and content of the operating statement must follow Section 13.12.B.5, below.

B. Long Form Cost Certification. For cases that do not qualify for simplified cost certification based upon paragraph A.1, above, please submit the following:

1. Borrower's Certificate of Actual Cost, Form HUD-92330, supported by an accountant's opinion (refer to Section 13.12.B.6).
2. Contractor's Certificate of Actual Cost, Form HUD-92330A, supported by an accountant's opinion (refer to Section 13.12.B.6), is required if there is an identity of interest with the borrower or if a cost plus construction contract was used.

3. Subcontractors, suppliers, and equipment lessor with an identity of interest with either the borrower or general contractor must submit Form HUD-92330A supported by an accountant's opinion.

a. Material suppliers. Attach to Form HUD-92330A a sheet showing:

- (1) Quantities furnished.
- (2) Sources from which the materials were obtained.
- (3) Unit prices paid to the sources, brand names, model numbers, sizes, lumber grades, etc., as applicable.

**NOTE:** No amount will be included for general requirements (e.g.: job overhead).

b. Equipment Lessor. Attach to Form HUD-92330A a sheet showing:

- (1) Dates the equipment was acquired,
- (2) Age of equipment at acquisition date,
- (3) Brand names and model numbers,
- (4) Sizes,
- (5) Dates and length of time used, and
- (6) Rates charged.

(a) The Lessor(s) must certify that:

- (i) The rates charged were not more than the local going rate obtainable in the area, including any maintenance and repair.
- (ii) The time charged was not more than essential for the project.
- (iii) The charges did not exceed the purchase price of the equipment.

(b) Lump Sum Basis. Instead of providing an attachment containing the above information, the lessor(s) may elect to certify to charges at 85% of the local going rates for identical equipment under arms' length (lump sum) leases. When using this alternative, the lessor agrees:

- (i) The Regional Center is the sole judge of the reasonableness of the time and rates charged, and
- (ii) Equipment maintenance and repair expense is the responsibility of the lessor(s) and is not included as an additional cost.

(c) Subcontractor's equipment. Costs for subcontractor(s) equipment, whether owned or rented, are considered in the markup for overhead and profit. These costs shall be reflected

in the total subcontract and in the prior approval of identity of interest entities. A separate certification of the equipment is not required.

(d) Manufacturer of Industrialized Housing. Attach to Form HUD-92330A, a breakdown of Division 13, Special Construction showing:

- (i) Manufacturing costs.
  - (a) Labor
  - (b) Materials
  - (c) Sales and any other taxes
  - (d) Factory overhead
  - (e) General overhead and profit

**NOTE:** The manufacturer's accounting system must follow generally accepted accounting procedures, which will allow certification of the actual cost of manufacturing by a Certified Public Accountant or Independent Public Accountant. No amount will be included for transportation or work at the project site.

- (ii) Transportation costs, factory to project site (if provided by manufacturer).
  - (a) Labor
  - (b) Equipment
- (iii) On-site erection costs (if provided by manufacturer).
  - (a) Labor
  - (b) Equipment
  - (c) Materials
  - (d) General requirements (job overhead)

(iv) The remainder of the manufacturer's Form HUD-92330A is completed per outstanding instructions.

**NOTE:** There can be no duplication of manufacturing costs, e.g., repair of components damaged in shipment.

4. An audited balance sheet of the borrower entity, as of the cut-off date is required.

a. The balance sheet must contain the following certification:

I HEREBY CERTIFY that the foregoing figures and statements contained herein submitted by me as agent of the borrower [owner] for the purpose of obtaining mortgage insurance under the National Housing Act are true and give a correct showing of (Name of borrower or owner) financial position as of (date of financial statement).

Signed this \_\_\_\_ day of \_\_\_\_\_, 20XX\_\_\_\_\_ (Signature of authorized agent with name printed or typed under signature)

WARNING: HUD will prosecute false claims and statements. Conviction may result in criminal and/or civil penalties. (18U.S.C. 1001, 1010, 1012; 31U.S.C. 3729, 3802)

- b. Furnish reconciling information if short-term liabilities on the balance sheet do not agree with Column B of Form HUD-92330.
  - c. Explain the purpose of all liabilities in the notes to the financial statement and include repayment requirements of the liabilities. Take special care to note any liabilities included for repayment on the balance sheet that were not disclosed during the firm processing stage or before initial endorsement. If such liabilities are found, inform the borrower that the liabilities cannot be an obligation of the project; repayment is the responsibility of the borrower. These liabilities will not be considered (allowed nor disallowed) in the review of the cost certification. When non-disclosures are found it requires a detailed review of cost certification Forms HUD-92330 and HUD-92330A.
  - d. If proceeds and obligations from project syndication are passed through the books and records of the borrower entity, reflect receivables as an asset of the borrower entity.
  - e. The notes to the balance sheet must identify the original amount of and summarize the expenditures from the working capital deposit.
5. An audited operating statement is required if occupancy occurs before the cost certification cut-off date.
- a. The statement must contain the certification contained in Section 13.12.B.4.
  - b. Prepare the operating statement on an accrual basis.
  - c. The statement covers the beginning of marketing and rent-up activities (or date of initial endorsement in rehabilitation projects where occupancy is continuous) to the cut-off date.
  - d. Marketing and rent-up activities will start no later than 6 months before the issuance of the first Permission to Occupy-Project Mortgages, Form HUD-92485.
  - e. The statement must show the actual dates covered rather than language such as "From the Date of Commencement of Marketing and Rent-up Activities, etc."
  - f. The statement must show income from all sources. Do not consider security deposits as income.
  - g. The operating statement should not contain any expense items that were paid or should have been paid from the working capital deposit or otherwise included in cost certification.
  - h. Operating expenses may include:
    - (1) Expenses directly relating to renting the project, such as:
      - (a) Rental commissions customary for the type of project, if any, and
      - (b) Marketing and advertising expenses.

- (2) Purchase of furnishings, fixtures, equipment and supplies not paid from the working capital deposit and in the eligible replacement costs.
  - (3) Reasonable fees for preparing any Federal, State, or local tax return information required of the project.
 

For example: If the borrower entity is a partnership, the cost of preparing both Form 1065, U.S. Partnership Return of Income, and related K Schedules may be considered. Do not recognize the cost of preparing a partner's personal Form 1040 return.
  - (4) Electricity, gas, water, and operating salaries (maintenance, cleaners, gardeners, elevator operators, etc.) to the extent they are not included in construction cost of Form HUD-92330, Borrower's Certificate of Actual Cost, or HUD-92330A, Contractor's Certificate of Actual Cost.
  - (5) Management fee stated in the contract.
  - (6) Services not covered by the management fee under Chapter 3 of Handbook 4381.5, Compensations for Management Services in Multifamily Housing Projects with Insured or HUD-Held Mortgages.
- i. Operating expenses may not include:
    - (1) Depreciation
    - (2) Interest, taxes, property insurance premiums, and mortgage insurance premiums that are reflected in Form HUD-92330, Borrower's Certificate of Actual Cost.
    - (3) Salaries paid to principals of the sponsor or borrower for managing the borrower entity.
  - j. Treatment of net operating income generated during construction:
    - (1) If the replacement cost mortgage (Criterion 3) is not the controlling mortgage, any NOI generated during construction may be applied to cover shortfalls in mortgageable soft costs, change orders, initial operating deficit and escrows. At final endorsement the balance of funds may be distributed to the borrower or deposited to the project's Reserve for Replacement account or applied toward the amortization of the mortgage principal.
    - (2) If the replacement cost mortgage (Criterion 3) is controlling the Mortgage Credit staff will do a calculation and determine if the interim NOI is equal to or greater than 1% of the original mortgage, and if it is, calculated interim NOI is deducted from the certified replacement cost amount. When the NOI does not meet this 1% threshold, apply the amount toward shortfalls, etc. as instructed in number 1 above. The Lender must deposit any remaining balance into the project's Reserve for Replacement account or apply it toward the amortization of the mortgage principal at final endorsement. There is no distribution to the borrower.
    - (3) For a non-profit mortgagor process:
      - (a) As a recovery of construction costs at cost certification, to the extent that it was used to reduce liquidated/actual damages.
      - (b) As an offset for a mortgage increase.
      - (c) Deposit the unused portion of net income into the project's Reserve for Replacement account at final endorsement.

- k. If operating expenses exceed income:
  - (1) No entry is made on Form HUD-92330, Mortgagor's Certification of Actual Cost.
  - (2) Operating deficit may be carried over as a reduction to net income on the supplemental operating statement.
- 6. A Certification by an independent Certified Public Accountant or an Independent Public Accountant must accompany Form HUD-92330, Mortgagor's Certificate of Actual Cost, including the audited balance sheet and operating statement of the borrower, and Form HUD-92330A, Contractor's Certificate of Actual Cost.
  - a. The accountant must meet the auditor qualifications of the Government Auditing Standards (GAO Yellow Book), including the qualifications relating to independence and continuing professional education. The audit organization also must meet the quality control standards of the GAO Yellow Book.
  - b. Part 24 of Title 24 of the Code of Federal Regulations prohibits accountants from contracting for services when their name is shown on the HUD and General Services Administration Government-wide Consolidated List of Debarred, Suspended and Ineligible Contractors and Grantees.
  - c. The accountant must also comply with the requirements in Chapters 1, 2, and 6 of HUD Handbook IG 2000.4, "Consolidated Audit Guide for Audits of HUD Programs."
- 7. The borrower must submit a supplemental operating income statement if more than 3 months exist between the cut-off date and the start of amortization. If a deferment of amortization was granted, (Section 13.27) use the new date for the start of amortization in determining the need for a supplemental operating statement.
  - a. This requirement does not apply to non-profit borrowers or any project where the mortgage is \$200,000 or less.
  - b. The statement covers the period from the cost certification cut-off date to the date, which is 3 months before the start of amortization. The borrower should submit the statement within 30 days after the expiration of this period.
  - c. If the required original cost certification was audited, a CPA or IPA must prepare and certify the supplemental statement.
  - d. The borrower may advance the date of amortization to avoid submitting a supplemental income statement.

- e. In preparing the statement, if the operating statement submitted at cost certification shows expenses in excess of income, such expenses may be carried forward as "un-recovered expense—prior period."
- C. Section 223(f) Projects. The borrower must certify to the total costs incurred in the acquisition or refinancing of the property using Form HUD-2205-A, Mortgagor's Certificate of Actual Cost. The certification must be dated and signed by an authorized agent of the borrower. An accountant's opinion is not needed.
1. The certification must be submitted after all critical repairs have been completed, but at least 15 days before the desired closing date.
  2. The general contractor will be required to cost certify using Form HUD-92330A if a cost plus construction contract is used.
  3. A balance sheet and income statement are not required.
  4. For cases involving deferred repairs, the borrower must submit a supplemental cost certification (Form HUD-2205-A) detailing the actual cost of the deferred repairs.
  5. No cost certification is required for a 207/223(f) refinancing transaction where the mortgage is equal to or less than 80% of value.

### **13.13 Deficiencies in Cost Certification Submission**

When the cost certification package is received for processing:

- A. The Cost and Mortgage Credit reviewers will:
1. Determine deficiencies associated with the borrower's and contractor's cost certifications.
  2. Advise the Regional Center Director and estimate the time needed to resolve the problem(s).
  3. Attempt to resolve all problems by telephone before making a formal written request. This usually allows processing to continue while waiting for a formal reply.
  4. Send a letter within 5 workdays to the borrower with copies to the general contractor (if applicable), their accountants, and the lender stating the deficiencies and requesting information.
- B. Upon receipt of all necessary information, combined processing should not exceed 15 workdays.
- C. If the borrower or contractor indicates clarification will be forwarded within 5 work days, the conclusions of cost certification can await the additional information.
- D. If not, issue Form HUD-92580.

### **13.14 Mortgage Credit Limited Review**

- A. In cases where the borrower has not requested a mortgage increase, the HUD staff will:
1. Review Form HUD-92330, Borrower's Certificate of Actual Cost. Adjust for items paid out of working capital and costs reflected on income statement.
  2. Review the reporting of:

- a. Net income earned before the start of amortization. Report all income earned from the beginning of marketing and rent-up activities to the cut-off date for new construction projects and unoccupied substantial rehabilitation projects. For substantial rehabilitation projects where occupancy is continuous, report all income from the date of initial endorsement or, for insurance upon completion cases, the start of construction to the cut-off date. Make adjustments for ineligible reported expenses, such as depreciation.
  - b. The reporting of all grants/loans received for replacement cost items.
3. Complete Form HUD-92580, Maximum Insurable Mortgage, using the figures from Column C, Total, of Form HUD-92330. Complete the forms based on the most current instructions, except for the following changes:
- a. Line 2. Reflect the amount indicated in Column C of Form HUD-92330.
  - b. Line 3. Explain any adjustments made to the net income or grant/loan amounts reported on Form HUD-92330.

**NOTE:** If adjustments are made to items other than net income and grants/loans, Form HUD-92331A should be completed.

4. When the borrower and the contractor submit their individual certificates of actual costs for review they should have already agreed to the amount due the contractor. The amount due the contractor is reported on the certificates of actual costs and there should be no disagreement because all “to be paid items” will be listed on the HUD-92580 schedule 1, item by item. The Form HUD-92023, Request for Final Endorsement of Credit Instrument, must match the Maximum Insurable Mortgage, HUD-92580 minus whatever was paid in the interim. As mortgage credit performs the cost certification and prepares the HUD-92580, consider the follow when reconciling the certified costs:
- a. After completion of the 92580 the Regional Center or Satellite Office notifies the lender/owner/GC of the balance in the line item for the GC, if there are issues then the Field will not move forward with the cost certification until all pending “to be paid items” are resolved.
  - b. The GC’s cost certification has to balance with the items remaining to be paid.
  - c. Mortgage Credit has to reconcile these numbers at cost certification, if there is a dispute all releases freeze until HUD/lender/GC come to agreement on who is owed what.
5. Report anything suspicious in the submission, (e.g. liabilities not disclosed during firm processing or before initial endorsement) to the Regional Center Director, who has the authority to request that a full cost certification review be completed. For such cases, complete Forms HUD-92331-A, and HUD-92580 based on the instructions in the Forms Book or on the multifamily internet site <http://www.hud.gov/offices/adm/hudclips/index.cfm>, and Section 13.16, below. Also, if an accountant’s work is consistently deficient, warn the accountant that borrowers using their services will be advised that HUD will perform a detailed cost certification review.

## 13.15 Mortgage Credit Detailed Review

When a mortgage increase is requested of the Regional Center Director, a more detailed review is required. The HUD Mortgage Credit staff will:

- A. Carefully review Forms HUD-92330 and HUD-92330-A if required for mathematical accuracy and compliance with prescribed procedures.
- B. Ensure that the submission contains required schedules and bills, which have not been submitted with previous draw requests, to support the certified amounts for interest, taxes, property insurance, MIP, title and recording, financing fees, legal, organizational and audit fees, offsite costs and other fees.
- C. Require clarification or breakdown of all, or any part of, the cost figures presented by the borrower or general contractor, if applicable.
- D. Scrutinize any existence of an identity of interest subcontractor, material supplier or equipment lessor relationship.
- E. Review the notes and schedules attached to the accountant's opinion. Pay special attention to any liabilities included for repayment on the balance sheet that were not disclosed during the firm processing stage or before initial endorsement. These liabilities are not eligible for inclusion in the cost certification.
- F. Recommend that the Regional Center Director request an audit of the borrower's and/or contractor's books by the Regional Inspector General for Audit before issuing Form HUD-92580, Maximum Insurable Mortgage, when differences of opinion arise from other than:
  - 1. Honest differences of opinion clearly identifiable as such.
  - 2. Other justifiable causes.
- G. If considerable time has passed between initial occupancy and the cut-off date, some items properly allocable to renting and operating the project may be charged against construction cost.
  - 1. It may not be possible or practical to make precise allocation of such items as gas and electricity, clean-up costs, etc., between construction and operation periods.
  - 2. Insist on reasonable allocations and eliminate duplicate claims for the expenses under both categories.
- H. Advise cost staff of any construction costs included in "Miscellaneous" and "Other" categories of Form HUD-92330.
- I. Check items and amounts in the borrower's cost certification without auditing the borrower's books and records. An audit may be needed later. (Refer to Section 13.29)
- J. Record the results of the review (including NOI) on Form HUD-92331A, Cost Certification Review Worksheet.

### **13.16 Allowable Costs in Borrower's Certificate of Actual Cost**

A. Construction Contract:

1. A lump sum construction contract is permitted when no identity of interest exists between the borrower and general contractor. The amount allowed in cost certification is the lesser of:
  - a. Actual cash paid or to be paid by the borrower under the construction contract.
  - b. Contract price as adjusted by HUD's estimated cumulative effect of approved change orders paid, or to be paid, by the borrower and the liquidated/actual damages provision to the contract, if applicable.
2. A cost-plus construction contract is required when an identity of interest exists between the borrower and general contractor.
3. The amount allowed in cost certification when a cost-plus contract is used is the lesser of:
  - a. Actual cash paid, or to be paid, by the borrower under the construction contract, or
  - b. Amount the cost analyst allowed for construction on Form HUD-92331, Summary of Cost Certification Review–Cost Section, or
  - c. Contract price as adjusted by the HUD estimated cumulative effect of approved change orders paid, or to be paid, by the borrower and, if applicable, either the incentive provision or the liquidated/actual damages provision of the contract.

**NOTE:**

- (1) Recognize approved change orders necessitated by errors or omissions by the architect only to the extent there are savings in the mortgage. Do not recognize these change orders when processing a mortgage increase.
  - (2) Do not recognize approved betterment change orders in calculating the adjusted upset price in paragraphs A.1.b and A.3.c, above, unless they are determined by the cost staff to be necessary changes as defined in Section 12.8.
  - (3) Recognize the increase in general requirements, if any, noted on approved time extension change orders. Do not recognize increases in soft costs associated with the change order. The soft costs will be recognized under the applicable line items.
  - (4) When BSPRA is not applicable, for profit motivated projects involving an identity of interest between the borrower and general contractor, the amount of builder's profit as shown on Form HUD-93305M is eligible whether or not it was paid in cash.
  - (5) For non-profit borrowers, the allowable builder's profit is the lesser of the amount actually paid or to be paid in cash to the general contractor or the amount of builder's profit shown in Section G of Form HUD-92264, plus or minus any amount applicable due to HUD-approved change orders.
4. An identity of interest is construed to exist when:
    - a. There is any financial interest of the borrower in the general contractor or any financial interest of the general contractor in the borrower.

- b. Any officer, director, or stockholder or partner of the borrower is also an officer, director or stockholder or partner of the general contractor.
- c. Any officer, director, stockholder, or partner of the borrower has any financial interest in the general contractor; or any officer, director, stockholder, or partner of the general contractor has any financial interest in the borrower.
- d. The general contractor advances any funds to the borrower.
- e. The general contractor supplies and pays, on behalf of the borrower, the cost of any architectural services or engineering services other than those of a surveyor, general superintendent, or engineer employed by a general contractor in connection with its obligations under the construction contract.
- f. The general contractor takes stock or any interest in the borrower corporation as consideration of payment.
- g. There exists or comes into being any side deals, agreements, contracts, or undertakings entered into or contemplated, thereby altering, amending, or canceling any of the required closing documents, except as approved by the Secretary.
- h. Any relationship (e.g. family) existing which would give the borrower or general contractor control or influence over the price of the contract or the price paid to the subcontractor, material supplier or lessor of equipment.

5. Incentive Fee Payments to Contractors.

The owner may request that the construction contract be modified before Initial Endorsement to provide for a general contractor incentive fee for completed construction work and delivering a completed project before the date specified in the construction contract (or as amended by HUD-approved time extension(s)). Incentive fees must be specified in an Addendum to the construction contract that has been approved by HUD before initial endorsement or at the execution of a construction contract that has been approved by HUD for Insurance Upon Completion and Insurance of Advance projects. An Incentive Payment Addendum may not be added to the contract after Initial Endorsement.

- a. Identity of interest borrower and general contractor.
  - (1) General contractor may benefit from savings in construction interest, taxes, property insurance, and mortgage insurance premiums to the extent there are construction cost overruns.
  - (2) Incentive payment is included in the adjusted upset price of the construction contract.

If there is an identity of interest between the borrower and the general contractor, an incentive fee may only be paid if there are certified cost overruns that were not included in a HUD approved change order, and the amount of the incentive fee may not exceed the amount of certified cost overruns that were incurred.

- b. Nonidentity of interest borrower and general contractor.
  - (1) Use Construction Contract Incentive Payment, Form HUD-92443.

(2) Include the incentive payment under “Other” on Form HUD-92331A.

Incentive fees must be calculated in accordance with Form HUD-92443. The incentive fee computed for Lump Sum construction contracts may not exceed 50% of the amount by which the estimated interest, taxes, property insurance and mortgage insurance premium, exceeds the certified costs for these same items through the actual date of completion.

The incentive fee computed for Cost Plus construction contracts may be paid in an amount calculated in accordance with the Incentive Payment Computation on page two of Form HUD-92443. Additionally, when the cost plus contract is used the **contractor may not** receive total payments that exceed: (1) the actual costs of construction, (2) the cash fee provided in the construction contract, or (3) the incentive fee as determined by the computation. (The contractor shall not be paid an incentive fee that is greater than the amount of cost overruns; the contractor must only receive the amount of the incentive fee. Any excess of this amount must be refunded to the borrower.)

6. Damages Clause. Apply the damages clause of the construction contract when the general contractor does not complete the project on time. The clause holds the general contractor financially responsible for the added soft costs resulting from the contractor’s delay.
  - a. Calculate the amount of actual damages and liquidated damages, using the lesser to determine the adjusted upset price.
  - b. To determine actual damages, compute the actual cost of interest, taxes, insurance, and MIP for the period from the scheduled completion date (as amended by HUD-approved change orders) through the substantial completion date.
  - c. To determine liquidated damages multiply the daily liquidated damages rate from the construction contract by the number of days between the scheduled completion date specified in the construction contract, as amended by the HUD-approved time extensions, through the substantial completion date.
  - d. Reduce the damages by the portion of the net operating income earned during the liquidated/actual damage period.
  - e. For those cases where an administrative completion date has been established, use this date for computing damages for cost certification purposes. However, the general contractor is responsible for damages through the date of substantial completion.
7. A borrower must be a single asset mortgagor entity and thus cannot act as its own general contractor, though there may be an identity of interest between the two parties.
8. Incomplete Minor Items. The borrower’s certification of the amount due under the terms of the construction contract may include the cost of minor items of on-site work that remain incomplete under the construction contract.

- B. Architect's fee(s) are limited to the amounts paid in cash.
1. Recognize the cost of additional services set forth in Article 10 of the Standard Form of Agreement between Owner and Architect for Housing Services, AIA Document B108. Ask Architectural and Cost staff to check the reasonableness of these charges.
  2. Disallow:
    - a. Any portion of the Architect's fee paid in stock.
    - b. Any costs associated with a clerk of the works.
  3. If any identity of interest comes into being between the Architect and either the borrower or general contractor during project construction:
    - a. See maximum design Architect's fee for cost certification purposes set forth in the Agreement and Certification, Form HUD-93305M.
    - b. Do not allow a fee for supervisory services to an identity of interest Architect.
  4. Treat any unused balance of the total Architect's fee as a direct mortgage reduction to the original mortgage amount on Form HUD-92580.
- C. Interest is allowable in the amount accrued on the first mortgage between initial endorsement (start of construction for insurance upon completion projects) and the cut-off date defined in Section 13.8.
1. Recognize interest costs associated with an approved early start provided:
    - a. The borrower entered into an agreement with the contractor which:
      - (1) Was approved by the Regional Center Director.
      - (2) Agrees to reimburse the contractor for interest on money borrowed for construction prior to initial endorsement.
      - (3) States that reimbursement will be made only to the extent the borrower has funds available in the amount estimated for interest during construction.
    - b. The certified amount, when added to the interest cost incurred directly by the borrower, does not exceed the total amount of interest estimated in Section G of Form HUD-92264.
    - c. Form HUD-92415, Request for Permission to Commence Construction Prior to Initial Endorsement for Mortgage Insurance, was executed and approved.
    - d. Interest costs reflect the contractor's actual cost of money borrowed to cover the cost of construction between the early start date and the initial endorsement as adjusted by paragraph e., below.
    - e. Rate of interest does not exceed the rate established for the insured loan.
  2. Interest rate paid on the construction loan cannot exceed:

- a. For insurance of advances: the rate stated in the Firm Commitment.
  - b. For insurance upon completion: the rate acknowledged by the Regional Center Director before issuing the Firm Commitment.
3. Deduct accrued interest forgiven by the lender or otherwise not paid in cash.
  4. Treat lender/bond underwriter's refund of any portion of the construction loan interest to the borrower or sponsor, as a direct mortgage reduction to the original mortgage amount on Form HUD-92580.
  5. If the construction interest rate changes before initial endorsement and it was not feasible to reprocess the project or if tax exempt bonds were sold to finance the construction loan and the true interest rate was not known until cost certification:
    - a. Interest savings may be created from the difference between the processed interest rate and the actual final interest rate.
    - b. Treat these savings as a direct mortgage reduction if the following condition was included in the Firm Commitment:
 

“Any interest savings resulting purely from a differential between the HUD processed interest rate and the actual construction interest rate may not be construed as excess funds that may be used to offset costs in other categories at the time of cost certification. Any such saving must be applied as a mortgage reduction.”
  6. Neither the interest on subordinated liens nor other obligations of the borrower are allowed as certifiable costs.
- D. Taxes are allowable in the amount accrued on the first mortgage between initial endorsement (start of construction for insurance upon completion projects) and the cut-off date defined in Section 13.8. Do not recognize costs accrued during the early start period.
- E. Property insurance is allowed in the amount accrued on the first mortgage between initial endorsement (start of construction for insurance upon completion projects) and the cut-off date defined in Section 13.8. Do not recognize costs accrued during the early start period.
- F. MIP. The FHA Comptroller's office cannot compute the exact amount of MIP due during the construction period until the project has been completed and the Washington Docket forwarded to Headquarters.
1. For a project involving insurance of advances, allow the higher MIP rate applicable to the specific FHA insurance program being used per annum on the mortgage amount on the basis of accrual for the number of days in the period used to Paragraph C above, when applicable.
  2. For a project involving insurance upon completion, no MIP is paid during construction.
- G. HUD application, commitment and inspection fees are allowable in the amounts paid. Fees paid to reopen an expired or terminated commitment are not allowable costs.
- H. Financing expense includes the initial service charge, discounts fees, Ginnie Mae, permanent lender commitment fees, and other similar fees.
1. Allow the lesser of:
    - a. Amounts paid, or to be paid, in cash.

- b. Amounts shown on Form HUD-92434M, Lender's Certificate (formally Mortgagee's Certificate), or Certificate of Lender portion of Form HUD-92455M approved by the Regional Center Director before Initial Endorsement (Insurance of Advances) or issuance of Firm Commitment (Insurance Upon Completion).
2. Construction lender's initial service charges (usually 2%). Construction and permanent lenders' fees in the aggregate cannot exceed 3.5% (5.5% for bond financed projects). The combination of origination, financing, and permanent placement fees must include the amount for lender's legal fee and is expected to cover the following:
    - a. Processing fees.
    - b. All expenses of the lender's counsel paid directly from the initial service charge. (Reconcile separate invoices or bills with the cost of the itemized figures.)
    - c. All other charges by the construction lender.
    - d. Excludes:
      - (1) Construction loan discount.
      - (2) Construction loan extension fees.
    - e. Any charges made by the lender for payment of counsel services or charge paid directly to the lender's counsel, to the extent they cause the initial service charge to exceed 2 percent, are not certifiable. *Except*, if charges are related to "Title and Recording" expenses certify these under the same category, see Section 13.16.I below.
    - f. Lender's permanent placement fee is usually 1.5%. It is expected to cover all permanent placement expenses except discounts and some of the fees associated with a bond financed transaction.
    - g. If Ginnie Mae Mortgaged Backed Securities are involved, the lender may not assess an additional charge for the MBS application fee or for the custodial or delivery fee.
  3. Recognize for cost certification:
    - a. Reasonable discounts based on current interest rates at the time of issuance of the Firm Commitment for projects involving insurance of advances and insurance upon completion charged by the construction and permanent lenders. Recognize extension fees charged by the construction lender if funded at initial endorsement and shown on the Lender's Certificate, Form HUD-92434M (formally Mortgagee's Certificate).
    - b. Permanent lender extension fees, shown on Form HUD-92434M, if funded before the substantial completion date.
    - c. For Insurance Upon Completion cases, construction and permanent loan extension fees, shown on the Certification of Mortgagee portion of Form HUD-92455M, if funded before cost certification cut-off.
    - d. Financing fees (including extension fees and discounts) paid on behalf of a borrower by a third party under Paragraph 18(f) of the Lender's Certificate or Paragraph 10h of Certificate of Lender portion of Form HUD-92455M and shown as a current liability on the borrower's balance sheet to the extent there are savings in the mortgage. At final endorsement, require a

promissory note be used for any unpaid balance of the obligation recognized in cost certification.

- e. For bond financed projects, cost of issuance, discounts, and financing fees in excess of 5.5%; provided the cost certification evidences that the sponsor/borrower cannot benefit monetarily from excess investment income from the proceeds of the invested obligations. Refer to Section 8.15.
4. Do not recognize for cost certification:
    - a. Any “side deals” (except for approved discounts) by which the borrower agrees to pay additional sums.
    - b. The 4% construction loan and 1.75% permanent loan Ginnie Mae indemnification escrows.
    - c. Discounts required to buy down the construction and/or permanent rate to a below market rate.
  5. Treat the following as a direct mortgage reduction at final endorsement:
    - a. Premiums paid by lender to the borrower or sponsor for acquiring the construction or permanent loan.
    - b. Partial refunds of the Commitment fee allowed in processing, which are returned to the borrower or sponsor.
    - c. Discounts or other fees paid for by a contribution of a portion of the initial service charge by the lender/bond underwriter.
    - d. Rebates paid to a borrower or sponsor by the lender/bond underwriter for bond -financed mortgages.
- I. Title and recording expense is limited to cash paid for:
    1. Title search and policy at the time of initial endorsement;
    2. Recording fees at initial endorsement;
    3. Mortgage and stamp taxes;
    4. Survey recording fees;
    5. Updating title policy during construction;
    6. Final title policy and recording charges; and
    7. Legal fees incurred with any of the above.
  - J. Legal, organization and audit expenses are limited to expenses incurred in organizing the borrower entity, developing the proposal to submit to HUD and other necessary governmental agencies and required services during closing and construction.
    1. Organizational allowance:
      - a. Allow only the amount included in Section G of Form HUD-92264 for the organizational fee, unless the borrower, who justifies the need for and reasonableness of the additional expenditure, submits fully supporting documentation.

- b. Any costs incurred in excess of this allowance are not eligible for recognition in processing a mortgage increase or the equity computation on Form HUD-92580.
  - 2. Limit the borrower's legal expenses to those incurred for: initial through final closings, tax advice during organization of borrower entity only, and preparation of documents and representation for and during organization of the borrower entity.
    - a. Allow customary expenditures expected to be incurred before and during initial closing, construction period, and final closing.
    - b. Do not allow:
      - (1) Expenses connected with land acquisition which is already included in, or contributing to:
        - (a) Title and recording expense.
        - (b) Estimated market price of site.
        - (c) Obtaining changes in zoning.
      - (2) Cost of legal services to create tax shelters, trusts, etc.
  - 3. Recognize cost of a "package deal" for organization and legal services provided:
    - a. Supplier is qualified to furnish the needed services.
    - b. Do not allow duplicate credit for the same services.
  - 4. Audit fee covers the cost of the accountant's audit and opinion of the borrower's certificate of costs.
  - 5. Amounts included in Form HUD-92264 for legal and audit expenses are not blanket allowances, but ordinarily set an upper limit on allowable amounts.
    - a. Non-typical fees must be borne by the borrower, unless in an exceptionally complex case, a higher fee is proven by the borrower to be necessary and reasonable. Detailed invoices and/or other documentation is required as to the reasonableness, purpose, necessity and proper classification of all items in the category.
    - b. This limitation is not flexible where a "package" for legal and organizational services is involved or where a substantial amount of the legal and organizational services are performed by the same firm.
- K. Offsite Costs. Where the borrower enters into a supplemental contract for constructing offsite improvements, allow the lesser of:
- 1. Contract price as adjusted by HUD's estimated cumulative effect of approved offsite change orders.
  - 2. Actual cash paid or to be paid for offsite work.

3. Amount allowed by cost analyst for offsite construction of Form HUD-92331, Summary of Cost Certification Review - Cost Section.

**NOTE:**

- a. The Valuation Branch must adjust the as-is land value of the property, if the allowed amount for offsite and demolition differs from HUD's estimate on Form HUD-92264 issued at Firm Commitment.
  - b. Offsite costs are not allowable for leasehold estates when the ground rent is based on a land value that reflects all required offsite improvements since the borrower has not paid for those improvements.
  - c. If the borrower certifies to off-site costs, the land value entered on Form HUD-92580, "Maximum Insurable Mortgage" will be reduced by the amount of off-site costs.
- L. Other costs include all costs and/or recovery of costs which are not provided for elsewhere and which are clearly attributable to the actual cost of the project.
1. Cost of acquiring the leasehold interest provided the acquisition cost plus ground rent and offsite costs paid by the borrower, if any; do not exceed the HUD Fair Market Value of the Land Fully Improved. Any excess is to be reflected as a disallowed cost of acquiring the leasehold.
  2. Ground rent paid during the period of the first mortgage between initial endorsement (start of construction for insurance upon completion projects) and the cut-off date as defined in Section 13.8.
  3. Incentive payment due a nonidentity of interest contractor for completing construction before the scheduled completion date as amended by HUD-approved change orders.
  4. Compensation from an insurance claim including any income earned by investing the proceeds of the claim. Treat as recovery of cost after computing BSPRA.
  5. Contractor's bond premium if paid by the borrower. If the construction contract contained an amount for the bond premium, subtract it from the contract amount when developing the adjusted upset price on line 1c of Form HUD-92331A.
  6. Other fees, including engineering and topographical survey. Cost staff must determine if such costs are reasonable and not duplicated in the general contractor's costs.
  7. Contingency reserve is included in the replacement cost of substantial rehabilitation projects.
    - a. The contingency reserve may be used for unforeseen costs of necessary items and betterment change orders approved by HUD and unanticipated soft costs for time extensions approved by HUD.
    - b. Expenditures for change orders and shortfalls in soft costs should be certified to and allowed under those specific line items.
    - c. Normally there will not be an amount certified to under contingency reserve since all expenditures will be certified to on other line items.
    - d. An itemization of all expenditures covered by contingency reserve funds must be attached to the cost certification submission.

8. Grants, governmental loans or tax credit equity used to pay for allowed cost items.
  - a. Should be treated as a recovery of cost after BSPRA.
  - b. Do not deduct grant, loan or tax credit equity funds from the total recognized costs when the funds were used to pay for the non-replacement cost items, i.e., used toward but not limited to: paying the acquisition cost of the land in excess of the HUD allowance, the operating deficit, working capital and items on Form HUD-2880, Applicant/Recipient Disclosure.
9. Residential relocation fund established on Form HUD-92264. Allow only those expenses approved by HUD up to the amount established on Form HUD-92264. Apply unused allowance as a direct mortgage reduction.
10. Third Party costs for appraisals, market analysis, PCNA etc., are no longer recorded in Other Fees and should be included with Organizational Cost line items (refer to Chapter 3).

M. BSPRA.

1. HUD does not control the division of BSPRA.
2. Compute BSPRA without regard to amounts on Form HUD-92264 based on a percentage of allowed costs.
  - a. Use the same percentage (not to exceed 10%) in the Firm Commitment review.
  - b. Exclude from the computation the cost of off-site work, land, payments for acquisition of leasehold, ground-rent, relocation expenses, and supplemental management funds, and Major Moveable Equipment, if applicable.
3. 50/75% rule.
  - a. Whether or not there is an identity of interest, no general contractor's fee (general overhead and profit) will be allowed when:
    - (1) More than 50% of the contract sum in the Construction Contract–Cost Plus, Form HUD-92442M, is subcontracted to one subcontractor, material supplier or equipment lessor, or
    - (2) 75% or more with three or less subcontractors, material suppliers and equipment lessors.

**NOTE:** If two or more subcontractors have common ownership, they are considered as one subcontractor.
  - b. Exceptions: The 50/75% rule is not applicable to:
    - (1) Manufacturers of Industrialized Housing.
    - (2) Trade items performed by persons on general contractor's payroll.

- (3) Supplemental Loan program.
  - (4) Rehabilitation programs other than substantial rehabilitation.
- c. The cost analyst determines the applicability of the 50/75% rule.
  - d. Where the 50/75% rule is violated, the general contractor forfeits its profit and only Sponsor's Profit Risk Allowance (SPRA) is allowed.
- 4. Where there is no identity of interest between the borrower and builder or when the 50/75% rule has been violated, compute a SPRA which is 10% of allowable:
    - a. Architectural fees.
    - b. Carrying charges and financing.
    - c. Legal, organization, and audit expenses.
  - 5. If an identity of interest between the borrower and general contractor is established after initial endorsement and exists at the time of substantial completion, BSPRA is allowed in lieu of a builder's profit and SPRA.
  - 6. If prior to the substantial completion date an identity of interest no longer exists between the borrower and builder, substitute SPRA for BSPRA.
    - a. The construction contract may be amended to permit a typical builder's profit.
    - b. Treat the difference between BSPRA and the combination of SPRA and builder's profit as a direct mortgage reduction on Form HUD-92580.
- N. Non-Profit Developer Fee. The allowable amount is included in the Firm Commitment less amounts certified and allowed on other line items.

### **13.17 Cost Review of Contractor's Cost Certification**

- A. Actual costs are all costs, paid by the general contractor under the Construction Contract for completion of the project, and to which the general contractor certifies, using Form HUD-92330A.
  - 1. Include actual costs paid in cash, or to be paid in cash (such as items of delayed completion), within 45 days after the date of the substantial completion, for labor, materials, equipment, subcontract work, general requirements (job overhead), fees and general overhead. Also include amounts estimated for any items requiring an escrow.

a. General Requirements:

- (1) May include salaries of clerical staff for time actually spent at the project site. Prorating of annual salaries on the percent basis is not permitted.
- (2) Salaries of executives may not be included in General Requirements. Such salaries are included in General Overhead.

b. General Overhead:

- (1) Include only the amount of the accepted Schedule of Values, Form HUD-2328, adjusted by the effect of approved change orders.
- (2) Itemization is not required.

2. Kickbacks, rebates, adjustments, discounts, or any other devices which the contractor may have received or is entitled to, must be deducted from actual costs.

B. For those cases where the borrower is not seeking a mortgage increase or a detailed review is not requested by the Regional Center Director:

1. The cost analyst will not review Form HUD-92330A, Contractor's Certificate of Actual Cost, in assisting the Mortgage Credit Examiner in the analysis of the borrower's cost certification.
2. The cost analyst will advise Mortgage Credit Examiner of the approved change orders.

C. Cost Review

1. Conduct a detailed review when the borrower applies for a mortgage increase or the Regional Center Director orders a detailed review.
2. Review certifications where required from the contractor, or any subcontractor, equipment lessor, material supplier or manufacturer of industrialized housing.
3. Forms necessary to make reviews:
  - a. Form HUD-92330, Borrower's Certificate of Actual Cost.
  - b. Form HUD-92330-A, Contractor's Certificate of Actual Cost.
  - c. Form HUD-93305M, Agreement and Certification.
  - d. Form HUD-92437, Request for Construction Changes—Project Mortgages.
  - e. Form HUD-92326, Project Cost Estimate (HUD Estimate).
  - f. Form HUD-2328, Contractor's and/or Borrower's Cost Breakdown.
  - g. Form HUD-92331-B, Cost Certification Review Worksheet.
  - h. Form HUD-92331, Summary of Cost Certification Review.
  - i. Form HUD-95379, Trip Report.
4. Steps to conduct the review:
  - a. 50/75% rule check. Use information from the "total" and "name of subcontractor or payee" columns of the general contractor's cost certification. If the rule applies, disallow the general contractor's general overhead and profit. If the project uses BSPRA, disallow only the general overhead and inform the Mortgage Credit Examiner.

b. Identity of interest subcontract review (for borrower, general contractor, subcontractors, equipment lessor, material suppliers, and industrialized housing manufacturers):

- (1) Examine Form HUD-93305M and Form HUD-92330-A to establish all declared identities of interest.
- (2) Review each identity of interest subcontractor's cost certification.

**NOTE:** If cost certification not received, disallow subcontractor's overhead, profit, and all questionable costs.

- (a) If no prior approval as an identity of interest subcontractor, disallow subcontract overhead and profit.
- (b) For prior approval:
  - (i) Allow prior approved subcontract overhead and profit, plus or minus the effect of approved change orders. Disallow excess.

**NOTE:** Do not reduce the prior approved subcontract overhead and profit in the event that the certified cost for the work is less than the prior approved maximum subcontract price.

- (ii) Allow up to the prior approved maximum subcontract amount for work, plus or minus the effect of approved change orders. Disallow excess.

5. Trade line item review:

a. On Form HUD-92331-B.

- (1) Enter all trade line costs from HUD estimate (Form HUD-92326) or Contractor's schedule of values (Form HUD-2328) after adjusting for approved change orders.
- (2) Enter all trade line costs from general contractor's cost certification (Form HUD-92330-A). Take architect's fees from borrower's cost certification (Form HUD-92330).
- (3) Using dollar and percentage variance columns compare each trade's actual cost with the estimate. Determine allowable amounts.

b. Allowable amounts are not limited by the estimates. Analyze differences.

- (1) Allow actual costs paid to complete the work in accordance with the construction contract.
- (2) Allow actual costs due to unusual circumstances, e.g., subcontractor bankruptcy, code changes, required replacement of completed work, replacements due to natural occurrences (storms, floods, earthquakes, etc.).

c. Question only amounts substantially in excess.

- (1) Contact general contractor and/or borrower requesting explanation or more documentation.
- (2) Make disallowances if explanation/documentation is not received in a reasonable amount of time.

(3) Only the accountant may make reallocation of monies from one trade item to another.

(4) As a result of discussion, have the accountant amend Form HUD-92330-A and resubmit.

- d. Disallow any amount not justified or supported as being part of the construction contract work.
- e. Disallow costs for duplication of work due to contractor's error or negligence, e.g., improper placement, failure to protect, noncompliance with contract, etc.

D. Summary of Cost Certification Review on Form HUD-92331.

- 1. Enter all recommended disallowances.
- 2. Enter summary of construction contract costs.
- 3. Enter contractor's profit from borrower's Form HUD-92330. Add profit from all HUD approved change orders.
- 4. Enter offsite costs from borrower's Form HUD-92330, if applicable.
  - a. Review itemized offsite breakdown.
  - b. Disallow any cost duplication on general contractor's Form HUD-92330-A.
- 5. Property Insurance Schedule, Form HUD-92329. Complete new form using allowed construction costs.

E. Lump Sum Construction Contract Cost Certification.

- 1. Review borrower's certification (Form HUD-92330) if requested to do so by Regional Center Director.
- 2. Review cost certification of any subcontractor that has identity of interest with the borrower.

### **13.18 Determination of the Non-profit Borrower's Initial Equity Investment**

The Non-profit borrower will be permitted a 6% return on its initial equity as computed on Form HUD-92580, Maximum Insurable Mortgage.

A. The base equity is determined as follows:

- 1. New Construction: Line 6, Form HUD-92580, minus finally endorsed mortgage determined in line 10 of the form.
- 2. Rehabilitation–Property Owned: Reduce the sum of line 4, Form HUD-92580, plus HUD's estimate of the "as is value" of the existing land and improvements before rehabilitation, by the finally endorsed mortgage determined in line 10 of the form.
- 3. Rehabilitation–Property Acquired: Reduce the sum of line 4, Form HUD-92580, plus the lesser of HUD's estimate of the "as-is value" of the existing land and improvements before rehabilitation or the acquisition cost of the property, by the finally endorsed mortgage determined in line 10 of the form.
- 4. Rehabilitation under Section 220 and 221(d)(4): Use the New Construction formula in paragraph A.1 above.

- B. The base equity computed in paragraph A.1 above may be increased by:
1. The cost of furnishing, fixtures, equipment or other necessary items and betterments essential to the operation of the project.
  2. The non-profit developer's fee used to reduce the estimate closing costs of the project.
  3. Grants from national, regional, and local community service organizations (non-government source).
  4. Sponsor's cash contribution for the cost of land over and above what HUD has allowed.
- C. Modify the Regulatory Agreement to require the return on equity be used for:
1. Continued affordable housing initiatives; or
  2. Pledged to the repayment of surplus cash or residual receipts notes held as secondary financing.
- D. Asset Management will monitor the non-profit borrower to be certain that the return on equity is used only for permissible purposes.
- E. The return on equity is paid from surplus cash/residual receipts. Any shortfall in the permitted return in one year may be made up from surplus project funds in a future year.

### **13.19 Determine the Borrower's Initial Investment**

- A. New construction and substantial rehabilitation projects under Sections 220 and 221(d)(4): Line 6, Form HUD-92580, minus the maximum insurable mortgage determined in line 10 of this form.
- B. The amount determined by above Paragraphs A may be increased by:
1. Expended working capital funds not recognized in the cost certification review.
  2. Residential relocation expenses approved by HUD in excess of the amount established on Form HUD-92264, Section G, and Section O, Remarks and Conclusions.
- C. Distributions. Mortgagor or any Affiliate or Principal shall not make, receive or retain any distribution of assets or any income of any kind from the project, except from Surplus Cash (per the Regulatory Agreement, Form HUD-92466M). This limitation does not apply to interim income generated during construction, but project income as it relates to the surplus cash calculation.

## 13.20 Section 223(f) Modified Form of Cost Certification

- A. Complete and submit a modified form of cost certification for review 15 days before the initial/final endorsement of the loan for insurance for all projects processed pursuant to Section 223(f); except those 207/223(f) refinancing transactions where 80% or less of value is the controlling criterion. (In such case cost certification is not required.) Unlike other cost certification procedures, savings from one line item cannot offset cost overruns on another line item. As you complete the cost certification and there is a cost savings, you must recalculate the maximum insurable mortgage. Refer to Form HUD-2205-A's instructions.
1. The borrower must certify to the total actual costs incurred in the acquisition or refinancing of the property. The certification must be submitted on Form HUD-2205-A, and it must be dated and signed by an authorized agent of the borrower.
  2. The lender must submit the certification to HUD for computation of the maximum insurable mortgage and completion of Section II of Form HUD-2205-A.
  3. If, in a purchase transaction, the amount of the acquisition cost determined allowable at cost certification exceeds the estimate of value, that was determined during processing, the rent formula shall be recomputed. This re-computation may be accomplished using the allowable acquisition cost as determined by cost certification and the dollar amount of secondary financing represented by the approved promissory notes (Form HUD-92223).
- B. The borrower must submit 15 days after repairs are complete a supplemental cost certification for deferred repairs for an escrow that was established at initial/final endorsement to complete non-critical repairs. In cases where the actual costs are less than estimated, you must recalculate the maximum insurable mortgage. If the maximum insurable mortgage is reduced based upon this recalculation of the lower actual costs, the borrower must either:
1. Have the required prepayment deducted from the repair escrow , or
  2. Deposit proceeds into the project's replacement reserve account, or
  3. Provide the required prepayment to the lender.

## 13.21 Special Instructions for Substantial Rehabilitation

**NOTE:** Cost certification instructions (set by statute) dictate that the lesser of the "as is" value of the land and improvements (before repair or rehabilitation) or the purchase price of the land and improvements, is used in the cost build up for Criterion 3 of Form HUD-92264-A, in substantial rehabilitation cases. Consequently, when mortgage proceeds will be used to fund the acquisition of the property, the "as is" value estimation will be used as a test of the reasonableness of the acquisition price.

When the acquisition price is less than the "as is" value of the land and improvements (as accepted by HUD), and mortgage proceeds will be used to fund the acquisition of the property, the acquisition price

will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment.

When the acquisition price exceeds the “as is” value of the land and improvements (as accepted by HUD), and mortgage proceeds will be used to fund the acquisition of the property, then the “as is” value will comprise the basis of the cost build up for the Firm Commitment.

When mortgage proceeds will not be used to fund the acquisition of the property, the “as is” market value of the property will be used in the cost build up for Criterion 3 forming the cost basis for the Firm Commitment. This is particularly significant when below market rent restrictions (such as in the case of LIHTC limited rents or Section 8 rent subsidy) are in place and the use of market rents in valuing the property will result in a premium over these rent restrictions. (See Section 7. 13.C, on defining how rents are derived as the basis for the “as is” value).

## **13.22 Mortgage Reduction after Cost Certification**

- A. The National Housing Act requires that the mortgage will not exceed the applicable percentage of actual costs. If certified actual costs are lower than original projected cost as reflected in Form HUD-92264, a reduction in mortgage may be applicable. The Agreement and Certification, Form HUD-93305M, also addresses this issue and provides that where the HUD accepts, for cost certification, estimates of cost for any item, the later substitution of certified actual costs may require a reduction of the mortgage.
- B. Reductions of cost may arise from:
  - 1. Refunds, rebates, or discounts.
  - 2. Excess of escrows over the actual costs of incomplete construction items.
  - 3. Refunds of deposits made by the borrower to prevent losses to the lender from loss in connection with sale of the mortgage.
  - 4. Settlement of claims against bonding companies or others after project completion.
- C. At final endorsement, the borrower must set up a cash escrow to pay all "to be paid in cash items" identified on Form HUD-92330, Borrower's Certificate of Actual Cost, and debts to third parties who made the original disbursement for an item listed as paid on Form HUD-92330.
  - 1. Reconcile the difference between:
    - a. Obligations listed on Form HUD-92023M, Request for Final Endorsement of Credit Instrument or HUD-92455M (for Insurance upon Completion Projects only), and
    - b. The "to be paid" column on Form HUD-92330 plus debts to third parties.
  - 2. Paid receipts must support differences and a statement from the borrower identifying by name and cost, those items paid in cash. The receipts and statement are affixed to Forms HUD-92023M or HUD-92455M.
  - 3. Do not accept personal or business checks issued by the borrower at final endorsement as evidence of payment. Payment must be in certified or cashier checks.

4. Prepare a new Form HUD-92331A to disallow obligations listed as "paid" or "to be paid" on Form HUD-92330, which are represented at final endorsement as paid by HUD-approved notes. Prepare a new Form HUD-92580 from the total of HUD-approved cost of revised Form HUD-92331A.
  5. Undisbursed mortgage proceeds may supplement or satisfy the cash escrow.
  6. Use Form HUD-92476.1M, Escrow Agreement for Non-Critical, Deferred Repairs (formally Escrow Agreement for Unpaid Construction Costs):
    - a. To set up the cash escrow.
    - b. Attach a detailed listing of the unpaid costs.
  7. Use Form HUD-92464M, Request for Approval of Advances of Escrow Funds to disburse escrow.
  8. Escrow should be disbursed within 45 days after final endorsement. If all of the funds are not disbursed follow the procedures in Section D below.
  9. At final endorsement, if all obligations have been paid in cash, nothing else is needed.
- D. Sixty days after final endorsement:
1. Prepare a new Form HUD-92331A. Enter under the column heading:
    - a. "92264" - the amount of each item of cost recognized from the earlier Form HUD-92331A "Allowed" column.
    - b. "92330/92330A" - the amount listed in Column C of the Borrower's Certificate of Actual Cost, Form HUD-92330, for each item of cost.
    - c. "Allowed" - the amounts paid in cash based on the reconciliation performed in Section B above and disbursements from the cash escrow account.
    - d. "Disallowed" - the lower of the amounts previously allowed or paid in cash.
  2. Compute a new Maximum Insurable Mortgage, Form HUD-92580, based on the total of the "Disallowed Column" (Form HUD-92331-A). If this computation produces an amount less than the mortgage finally endorsed:
    - a. Notify the Directors of Housing Production and Management by memorandum that prepayment to the mortgage is required.
    - b. Prepayment is mandatory and is applied:
      - (1) In amounts equal to the scheduled monthly principal payments, to the extent possible.
      - (2) Any remainder goes to the Reserve for Replacements Fund.
    - c. If HUD is notified that payment has been delayed because of a dispute or litigation, retain funds to pay the amount pending resolution of the dispute.
    - d. Notify the lender or escrow agent by letter of the required prepayment.
    - e. Control the remaining balance in a special account, as a reserve for unpaid construction costs from which disbursements may be made only after written consent of the Regional Center or Satellite Office.
  3. The lender will continue to use the existing amortization schedule for servicing the mortgage.

- a. The prepayment is in addition to the regular monthly payments to principal.
  - b. There is no adjustment in the amount of the annual MIP due because of these mandatory prepayments.
4. The escrow requirement does not apply to funds the general contractor owes. However, the general contractor must submit a reconciliation of its "to be paid" items.

### **13.23 Increase in Mortgage Amount**

- A. Timing. Requests for a mortgage increase will not be considered until the project is complete, cost certification has been submitted, and the Final Endorsement will likely be achieved immediately following processing of the mortgage increase and the conditions in paragraph B below are met.
- B. Bases for considering a mortgage increase:
1. Necessary changes that arise from differing site conditions (as defined in the construction contract).
  2. Compliance with local codes.
  3. Unforeseen conditions that might affect the safety and health of occupants.
  4. Betterment changes that are economically justified e.g., those that produce significant cost savings to project operation, can be reflected in increased income expectancy, or enhance the security of the mortgage.
  5. Costs caused by extensions in construction time, when such extensions: are approved by HUD; justifiable under AIA General Conditions; and caused by problems beyond the contractor's control. Other costs not known at Firm Commitment resulting from requirements of local authorities and beyond the borrower's control.
  6. Construction hard cost increases caused by a natural disaster declared by Federal or State government, to the extent not covered by casualty insurance.
  7. Increased costs resulting from concealed subsurface site conditions, provided it is determined those exploratory tests during project design were sufficient and thorough and neither the architect nor engineer was at fault.
  8. Cost of substituting a general contractor when the original general contractor is terminated for cause and the surety has failed to perform.
  9. To correct a substantial HUD error in the original processing that would otherwise result in serious inequities.
  10. Any mortgage increase for an insured project must be more than 2.5% of the original mortgage and at least \$50,000.

## **13.24 Restrictions on Mortgage Increases**

- A. A mortgage increase may not be granted for cost overruns associated with: completion of the work in accordance with the original contract documents by the original contractor, changes made primarily for the convenience of the borrower or contractor, nor for the aggrandizement of the borrower or contractor.
- B. Cost overruns are not a basis for granting a borrower's request for mortgage increase nor are changes made primarily for the convenience or aggrandizement of the borrower or contractor.
- C. Any mortgage increase for an insured project must be more than 2.5% of the original mortgage and at least \$50,000.
- D. The increase must be supported by net income under Criterion 5 of Form HUD-92264-A.
- E. A mortgage increase may not be granted for replacing a contractor where the borrower sets up a "straw contractor" for purposes of BSPRA.

## **13.25 Processing a Mortgage Increase**

Technical processing consists of Step One through Step Four below. The four steps to processing a mortgage increase, depending on the condition being considered:

- A. Step One: Use the alternative applicable to the condition being considered:
  - 1. Alternative One, applicable to necessary items and betterment change order cost increases:
    - a. Architecture and Valuation staffs review the change orders to determine eligibility for processing a mortgage increase. Architecture further reviews for the added cost.
    - b. Mortgage Credit computes the allowable costs on Form HUD-92331-A, Cost Certification Review Worksheet–Mortgage Credit Staff, Line 1.d. Reduce this amount by the cost attributable to any change order(s) not qualifying for a mortgage increase.
    - c. The adjusted hard cost forms the basis of the mortgage increase computation
  - 2. Alternative Two, applicable to contract time extension soft cost increases:
    - a. Mortgage Credit computes the allowable costs on Form HUD-92331-A, Cost Certification Review Worksheet–Mortgage Credit Staff, Line 3 through 6.
    - b. The adjusted soft cost forms the basis of the mortgage increase computation.
  - 3. Alternative Three, applicable to construction contract cost increases due to a change in the contractor:

- a. A&E staff computes a new Form HUD-2328 and Form HUD-92264, Section G through Line 50.
- b. Mortgage Credit staff computes the allowable costs of Form HUD-92331-A, Cost Certification Review Worksheet–Mortgage Credit Staff, Line 1.c. for hard cost increases between the original contractor and the contractor completing the work, and Lines 3 through 6 for soft cost increases associated with the change in contractor.
- c. The adjusted hard and soft costs form the basis of the mortgage increase computation.

4. Alternative Four, applicable to substantial error in HUD cost processing:

- a. A and E staff complete a new Form HUD-2328, and Form HUD-92264, Section G through line 50.
- b. Mortgage Credit computes the allowable costs on Form HUD-92231-A, Cost Certification Review Worksheet–Mortgage Credit Staff, Line 1.c, using the criteria in paragraph c. below.
- c. The allowable construction costs for processing the increase will be based upon the lesser of:
  - (1) The amount of the construction cost certified by the borrower, or
  - (2) The upset price of the construction contract as adjusted by approved change orders eligible for a mortgage increase, plus the increases resulting from correcting or errors in the original processing.
- d. The adjusted hard cost forms the basis of the mortgage increase computation.

**NOTE:** The mortgage credit examiner must not use the adjusted upset price of the construction contract as a limiting criterion at cost certification where there is a substantial error in HUD cost processing.

B. Step Two: Mortgage Credit must compute (for use by Valuation in completing Form HUD-92264) the eligible costs and fees for the following: architect’s fees, bond premium if paid by the borrower, other fees not included in the construction contract and paid by the borrower, interest, taxes, insurance, developer’s fee (if applicable), legal, organizational and audit fees, marketing (if applicable), offsite costs, as-is land value and “as-is” value of property (if applicable). Mortgage credit must comply with the following in computing the costs and fees.

- 1. Do not increase BSPRA or restore Contingency Reserve or non-profit’s Developer’s Fee.
- 2. Do not include non-mortgageable items (construction or permanent loan extension fees; discount rate, maintenance fees, etc.)
- 3. Offset non-mortgageable items by net income (net non-proprietary income, if applicable) to offset amount of mortgage increase, and
- 4. For increases caused by natural disaster:
  - a. Consider in the revised cost any increases from any interim closing for: carrying charges, financing fees, and legal fees. Do not include any cost due to construction delays before the disaster,

- b. Cut the new estimated replacement cost by the amount of any actual recovery through insurance proceeds, and
  - c. Require prepayments to be made for any late recovery of insurance proceeds.
- C. Step Three. Valuation must use the costs and fees developed by Mortgage Credit in Step Two in revising Form HUD-92264. Valuation must consider each of the following:
  - 1. Examination fee, initial service fee, Ginnie Mae fee, inspection fee, MIP, and title and recording based on the approvable increased mortgage amount.
  - 2. Net income derived from market rent, expense and occupancy estimates current as of the date of mortgage increase processing.
- D. Step Four. Mortgage Credit must prepare a revised Form HUD-92264-A, using the revised Form HUD-92264 and Trial Form HUD-92264-A prepared by Valuation in Step Three.

### **13.26 Authorization to Reopen Mortgage Transaction**

- A. HUD must advise the lender of its approval or denial of the request for a mortgage increase upon completion of technical processing. Use Specimen Letter–Agreement Authorizing Reopening of Mortgage Transaction (Appendix 13A), to notify the mortgagee, where a determination is made to increase the mortgage.
  - 1. Approval of a mortgage increase is subject to the payment of the following fees based on the amount of the increase.
    - a. Application Fee of \$3.00 per thousand of the increase.
    - b. Inspection Fee of \$5.00 per thousand of the increase is applicable only when the increase involves construction hard costs.

### **13.27 Deferral of Principal Payments**

The lender must obtain an agreement from the investor in the Ginnie Mae security and support the request for deferral of principal payments.

- A. HUD may consider requests for deferral if:
  - 1. There is a delay in construction; or
  - 2. The project requires additional time to reach sustaining occupancy.
- B. HUD may approve the request when:
  - 1. There are sufficient funds outside the mortgage proceeds for payment of interest overrun confirmed either by:
    - a. Written assurance from the sponsor, or
    - b. Exercise of action against the contractor.

2. The borrower shows reasonable effort to complete construction and attain sustaining occupancy.
- C. The period of deferment is the additional time necessary for the borrower to stabilize its operation.
- D. Deferment Letter. Use Appendix 13B, Specimen Letter – Agreement Authorizing Deferment of Principal Payments for Level Annuity Monthly Payment, and distribute copies in accordance with Section 13.28 below.
- E. Deferment Instruments. The Regional Center Director is authorized to approve modifications of the principal and interest payment as may be necessary to effect the deferment of principal payments.

### **13.28 Document Distribution**

- A. Form HUD-92580, Maximum Insurable Mortgage.
  1. Lender—original and one executed copy.
  2. One executed copy to each of the following: Closing Attorney, Mortgage Credit Control File, Washington Docket, Regional Center or Satellite Office Docket, Regional Center or Satellite Office Valuation Data Bank.
- B. Cost Certification Documents. Original documents filed in the Washington Docket and one copy in the Regional Center or Satellite Office Docket.

### **13.29 Office of Inspector General**

The Regional Center Director should refer borrowers to the Office of Inspector General to evaluate the borrower's and/or contractor's books where discrepancies appear to arise from other than inadvertent error, or creditable misinterpretation of applicable criteria. Do not issue Form HUD-92580, Maximum Insurable Mortgage, before completion of an OIG audit or investigation initiated before its issuance. A referral must also be requested for any indicated fraud or material misrepresentation detected after issuance of Form HUD-92580.

### **13.30 Cost Certification Incontestability**

After HUD approves the certifications and issues Form HUD-92580, Maximum Insurable Mortgage, they are final and incontestable unless there is fraud or material misrepresentation by the borrower, general contractor, or subcontractors.

### **13.31 Post Closing Escrows**

Post-Closing Escrows must be set up at final closing to pay all “to be paid in cash” items identified on Form HUD-92330, Borrower’s Certificate of Actual Cost, and debts to third parties who made the original disbursement for an item listed as paid on Form HUD-92330. These amounts may be adjusted for payments made between the cut-off date and the date of final closing.

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# Chapter 14

## Low Income Housing Tax Credit (LIHTC) and Other Tax Credit Program Guidance

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### 14.1 Introduction

The Low Income Housing Tax Credit (LIHTC) program was enacted as part of the Tax Reform Act of 1986. It is administered by the Treasury Department and State Housing Finance Agencies (HFAs). In July 2008, the Housing and Economic Recovery Act (HERA) provided statutory rulings for FHA multifamily program changes, to facilitate the use of insured mortgages with LIHTC developments.

This chapter outlines policies and procedures for underwriting and reviewing FHA multifamily mortgage insurance applications for projects using Low Income Housing Tax Credits. Standard processing of such applications applies except as modified below, and all Tax Credit projects are underwritten using the “single underwriter model”. Underwriters assigned Tax Credit Projects must have specialized training for Tax Credit Project underwriting. Guidance provided here addresses all LIHTC projects underwritten for FHA insurance but additional, separate guidance is also provided for LIHTC projects that are processed through the FHA Tax Credit Pilot Program, referred to using the full program name or as “the Pilot Program.”

### 14.2 Affordable Housing Underwriting and Program Guidance In Other Parts of the MAP Guide

Guidance for processing and underwriting insured loans for affordable housing projects under the various mortgage insurance programs can be found in several other chapters of this Guide, noted in the chart below:

<b>MAP Guide Section Number</b>	<b>Content</b>
Section 2.7	Identities of Interest are permitted between lenders and equity syndicators, investors or bridge loan lenders, in limited circumstances.

Sections 3.2 & 4.2.B.	Tax Credit projects usually go “direct-to-firm”, but if two stage processing is used, no pre-application fees are charged for LIHTC or other affordable projects.
Section 3.3	Loan sizing ratios under 221(d)(4) are provided, and these apply to Tax Credit projects underwritten for that program, unless adjusted for the FHA Housing Tax Credit Pilot Program in separate guidance.
Sections 3.4, 3.5, & 3.7.	Loan sizing ratios under 220, 223 and 231 are provided, and these apply to Tax Credit projects underwritten for each program.
Section 3.7	Loan sizing ratios under 223(f) are provided, and these apply to Tax Credit projects underwritten for that program, unless adjusted for the FHA Housing Tax Credit Pilot Program in separate guidance available as of this writing.
Section 4.1	One stage application processing is permitted for all Tax Credit projects under all Sections of the Act.
Section 5.8	Streamlined processing (including delayed submission of final plans) is permitted for Tax Credit projects, assuming certain conditions are met.
Section 7.5.A	No market study, other than that which would be provided in the appraisal, is required for projects with 90% or more project based rental assistance.
Section 7.5	Requirements for market studies, applicable to all SOAs if required.
Section 7.9.I.	Estimating the land value of Tax Credit projects.
Section 7.14	Calculating operating deficits (for all Tax Credit projects.)
Section 7.16	Recognizing tax abatements in the underwriting, and waivers of certain underwriting requirements for Tax Credit projects.
Section 7.17	Valuation of Tax Credit and other affordable properties.
Section 8.3	Identifying the principals in an LLC, LP or non-profit for purposes of mortgage credit review and limited review of tax credit equity syndicators and passive investors.
Section 8.4	Financial requirements of sponsors of affordable projects.
Section 8.7 & 8.8	Determining the mortgage amount and cash requirements; no escrowing of tax credit equity during construction; and Firm Commitment special conditions for deferred equity installments.
Section 8.9	Requirements for secondary financing from governmental lenders and for bridge loans used to fund equity during the construction period; use of HUD’s form of Subordination Agreement instead of Note Rider.
Section 8.7	Requirements for grants and loans, and for various tax credits including the LIHTC, from governmental sources.
Section 8.12	Evaluating mortgage credit of non-profit sponsors.
Section 8.8 and 8.13	Cash requirements for Tax Credit projects, including working capital and operating deficit escrows.
Section 8.14	Requirements for tax exempt bond financing.
Section 13.4	No cost certification required for tax credit project loans under 80% of cost.

### **14.3 Historic and New Markets Tax Credits**

Generally the LIHTC-related provisions of the Guide that are applicable to all LIHTC projects (within and outside of the Pilot Program) are also applicable to projects using Historic and New Markets tax credit equity. However these other tax credit programs are not housing based: New Markets Tax Credits are administered by the Community Development Financial Institutions Fund, or “CDFI” Fund, (a program within the U.S. Department of the Treasury), while the Historic Tax Credits are administered by the National Park Service, the Internal Revenue Service, and the State Historic Preservation Offices. These programs are only occasionally used in FHA-insured projects, so no further policy is provided in this chapter. However, to the extent it is legally permissible and consistent with FHA’s mortgage credit and underwriting standards, other tax credit programs can be used in a manner similar to that described below for LIHTC projects. Further detail is provided in Chapter 16.

### **14.4 Subsidy Layering Review**

Subsidy Layering Review requirements have been eliminated for LIHTC projects using FHA-insured loans but no other sources of Federal subsidy. Thus, most of HUD’s mortgage insurance transactions are exempt from the formal subsidy layering review. The lender and underwriter must always review the Sources and Uses statements for both mortgageable and non-mortgageable funds however, to ensure that costs are not being funded twice and that all costs funded from mortgage proceeds are appropriate and necessary to complete the transaction.

In addition to the analysis of the Sources and Uses in the FHA loan underwriting, other public funds combined with the FHA mortgage in a Tax Credit project may require a formal Subsidy Layering Review. These public funds might include HOME and other Federal Loans, secondary financing provided from state or local sources, or capitalized debt supported by above-market, budget based Section 8 rents. If those funds require a Subsidy Layering Review, either a state agency, another public source or HUD will perform the review based on the FHA MAP Lender’s analysis. Criterion 11 on the *Supplement to Project Analysis* (HUD Form 92264-A) is not required. It may be used as an optional worksheet.

### **14.5 Evidence of Tax Credit or Private Activity Bond Cap Allocations**

The Firm Application for any LIHTC project should include evidence of 1) an LIHTC award in the form of a 9% State Agency Allocation or in the case of 4% Tax Credits, an allocation of private activity bond cap<sup>4</sup>, or 2) in the case of Historic Credits or New Market Credits, an equivalent form of verification from

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<sup>4</sup> Note that in some states this general rule is not workable, because, for example, states may require evidence of FHA loan commitments before the allocation can be made, or other timing difficulties arise. In such cases final allocations will not be required until later in the process.

the appropriate agency. However, LIHTC allocation timing varies by state and in some cases FHA applications must be submitted before final allocations of tax credits can be secured. Accordingly other evidence is allowable, for example state agency bond cap allocators' assurances and written procedures stating that bond cap remains available for the period in question, that an application has been submitted for the project in question, that allocations are obtainable in the time available, etc., in the case of 4% LIHTC allocations.

## **14.6 Single Underwriter and Technical Reviews**

The "single underwriter model", which gives the HUD Underwriter responsibility and discretion to determine what level of technical review is needed in several elements of the underwriting, has been implemented for all MAP loans. The assigned underwriter has discretion to obtain full or partial technical reviews, or to waive technical reviews, other than Environmental site visits and completion and certification of the Environmental Review in HUD HEROS Form 4128.

## **14.7 Treatment of HAP Contract Renewals for Section 8 Assisted Tax Credit Projects**

Rental assistance for LIHTC projects with Project Based Section 8 Rental Assistance ("Assisted Projects") should take the form of a 20-year, Project Based Rental Assistance Section 8 Housing Assistance Payment (HAP) contract or a 15-year Project Based Voucher contract.

Rent Comparability Studies ("RCSs") form the basis of and must be completed in advance of any loan application, because they provide justification for rent increases and are a requirement of the HAP Contract Renewal Request. The lender must review the RCS as part of the underwriting process and take its conclusions into account when reviewing the MAP appraisal. If the borrower commissions the RCS, the same firm cannot do the appraisal. However if the lender commissions the RCS, the same firm can also do the appraisal. The lender is expected to underwrite the loan using the rents from the RCS to develop income and expense estimates (and/or the Section 8 budget prepared by the borrower in the case of budget based rents) and to address any inconsistencies carefully in the lender's narrative. The HUD Underwriter will review the Section 8 HAP contract request, RCS and lender's underwriting narrative to verify that the rents requested by the borrower in the HAP contract renewal request are supported by the RCS, and that the lender's underwriting is in line with both the RCS and the contract renewal request. At the HUD Underwriter's discretion the HUD appraiser may be asked to review an RCS to determine its reasonableness. However if the Performance Based Contract Administrator's<sup>5</sup> ("PBCA") appraiser has

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<sup>5</sup> The PBCA is an agency hired to assist HUD/OAMPO in the administration of Section 8 contracts.

not undertaken a detailed review of the RCS, the HUD appraiser must also review the RCS to determine reasonableness using Guidelines in Chapter 9 of the “Section 8 Renewal Policy”.

Close coordination among the assigned HUD Underwriter, the field office’s Office of Asset Management and Portfolio Oversight (OAMPO) representative assigned to the project, and if necessary, HUD HQS’ OAMPO staff is essential to ensure that a) the Section 8 HAP contract renewal request and rent increase, if applicable, are approved in a timely fashion, b) a prepayment approval is obtained if needed, and c) any other waivers are processed and approved in a timely fashion.

Section 8 HAP Renewal Requests and Rent Adjustment Requests must be delivered to the Performance Based Contract Administrator (PBCA) at least 60 days prior to the submission of the LIHTC Firm Commitment application, and 120 days in advance is preferable. However, the Rent Comparability Study, or “RCS” rents and the appraiser’s rents must be determined within 180 days of the issuance of the Firm Commitment, or those rents must be updated according to Part 7.6.B. Thus the owner and lender must manage the timing accordingly. The rents, expenses and debt service figures used in the lender’s underwriting must be consistent with those in the Section 8 contract renewal request. Lenders should assist borrowers to ensure that requested (and subsequently approved) rents are consistent with the underwritten rents. Similarly, lenders’ requests for prepayment of an FHA insured loan should be submitted to headquarters well before submission of the Firm Application package to the HUD field office. The PBCA working under the direction of OAMPO prepares and signs the new contract and an attached cover letter for delivery to the owner.

Section 8 subsidized Pilot Program projects require owners to execute a 20 year HAP contract (except for Mark-to-Market (M2M) projects that received exception rents). RAD projects are eligible for the Pilot as long as at least 90% of their units are Section 8 assisted, and they have new 15-year Project Based Voucher contracts. In many cases this will require HUD to authorize the Owner to terminate the existing HAP contract for the purposes of executing a new 20 year HAP contract. If the project is operating under a multi-year term contract, the Owner and HUD must, by mutual agreement, terminate the existing HAP contract and execute a Renewal Contract with a new 20 year term, subject to the policy at the time and the availability of appropriations. The Owner must also execute an Exhibit to the Section 8 HAP contract, agreeing to renew the HAP contract again at the end of the new 20-year term, for at least the number of years remaining on the contract in place at the time of the early termination. This requirement is contingent on the availability of funding with such terms at the time of the renewal. The Preservation Exhibit must also be executed.

An exception to the HAP Renewal Request requirement may be made if the borrower has renewed the project’s contract for a 20 year term within the 12 month period prior to the anticipated closing date of the new FHA-insured loan. In such cases the lender is to submit a copy of the borrower’s HAP Contract Renewal Request that lists any requested rent adjustment (which must be supported by either a Rent Comparability Study, a budget, or both, in accordance with OAMPO requirements as stated in the Section 8 Renewal Policy Guidebook, Effective 11/5/15).

If the borrower requests a market-based rent increase on a substantial rehabilitation project at “post rehab” market rent levels to support a new 221(d)(4) insured loan at initial closing, a Section 8 escrow will be required to fund the difference between the existing rents and the post-rehabilitation rents during the construction period. Lenders should include this escrow in their underwriting. Alternatively under the Section 223(f) program a waiver of the prohibition against post rehab rents during construction can be obtained. Borrowers and their lenders should refer to the Section 8 Renewal Policy for details on post-rehabilitation rents.

A copy of the HAP Contract Renewal Request must be included in the LIHTC project mortgage insurance application. It demonstrates that the rents requested by the borrower match the rents used in the underwriting submitted by the lender, and it serves as evidence that the borrower has in fact submitted the request for the contract renewal/rent increase. If the borrower is submitting a budget-based rent request, the lender must coordinate with the borrower to determine a preliminary debt service figure for the new loan that the borrower will include in the proposed budget to submit to HUD and the PBCA. The final debt service figure is subject to change during the final underwriting process, so this may have to be amended on the HAP contract request later. The income, expenses and debt service figures listed on the borrower’s request must match the figures in the lender’s underwriting. Specific forms and documentation for inclusion in the Firm Approval Application include the following:

- A. Project Rent Comparability Study prepared for the Section 8 contract renewal must be submitted with the LIHTC Firm Approval Application.
- B. MAP-compliant appraisal and HUD forms 92264, 92273 and 92274 are required. However, appraiser may opt to use the 92273 used in the Rent Comparability Study or another format and may use Form HUD 92274 or an alternative format acceptable to the lender and the HUD Underwriter for expenses.
- C. The information supplied in the RCS and required by OAMPO for the rent increase/contract renewal request is the same information required for the Firm Application on forms 92273 and 92274, so there is no need for the lender or the lender’s appraiser to recreate the information on a form for the application. The HUD Underwriter may also consult iREMS for historic rental income and project expense information if this information is helpful to verify the income and expenses used in the underwriting. HUD’s Single Underwriter will perform a desk review of the appraisal and the lender’s appraisal analysis for Assisted Housing projects: This review is delegated to the project’s approved MAP lender.

Note regarding RAD/FHA/LIHTC Projects: HUD has issued separate guidance for Rental Assistance Demonstration projects with regard to the underwriting of RAD transactions with FHA-insured loans and LIHTC.

## 14.8 Application/Submission Requirements

The following describes application requirements for all Tax Credit Projects, that differ from those described in other sections of the MAP Guide for projects without Tax Credits. Other application documents specific to the Pilot Program are listed in a separate Tax Credit Project Application Exhibits Checklist.

- A. Lender's Application Form. The Tax Credit Program Pilot Lenders' Narrative template can be used for all Tax Credit Projects and is available on HUD's Tax Credit Pilot website at:  
[http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/mfh/map/maphome/taxcredit](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/map/maphome/taxcredit).
- B. Data Submission. A tax credit version of the "Wheelbarrow" or similar document set up to provide specialized information with respect to sources and uses of funds, draw schedules and other matters essential to analysis of LIHTC projects, must be submitted for all Tax Credit projects in place of the standard Wheelbarrow. It is a substitute for Forms 2264a and 2264, and it is available on HUD's Tax Credit Pilot website at:  
[http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/mfh/map/maphome/taxcredit](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/mfh/map/maphome/taxcredit). This Wheelbarrow may be used for all Tax Credit projects.  
Other standard documents will be those used for a given project's SOA program.

## 14.9 Architecture and Engineering

- A. Tax Credit refinancing and substantial rehab projects must conform to all current CNA requirements.
- B. The ALTA Survey submission may be waived for Tax Credit transactions involving the refinance of a project with an existing FHA-insured mortgage, if the new FHA borrower submits a statement reviewed and approved by the MAP lender and certifying that there have been no material changes or additions to the structure or property boundaries since the closing of the original loan. Accordingly HUD may accept an existing survey for such projects rather than requiring a new survey document.
- C. 100% Complete/Final Plans and Specs may be delivered after Firm Commitment but no later than 30 days prior to closing, so long as sufficient time is allowed for review prior to closing. If the documents evidence a cost increase of 5% or more compared to prior plans and specs, further review will be required as described in Part 5.6. D. and E.
- D. Other Documents: A Specialized Checklist for Application Submissions on Tax Credit Projects is available at the following link:

[http://portal.hud.gov/hudportal/documents/huddoc?id=Appendix\\_D\\_Checklist.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=Appendix_D_Checklist.pdf)

## 14.10 Mortgage Credit Review for Tax Credit Projects

- A. Non-profit Sponsors' Mortgage Credit Requirements. Non-profit board members are excluded from the Previous Participation Review submission requirements. Only officers of the non-profit and board members who serve as officers of the board (e.g., the President or Chair of the Board, the Vice President, Treasurer and Secretary) are required to prepare and submit the Previous Participation Review. However other LIHTC project principals must meet standard requirements.
- B. Passive Investors' and Syndicators' Mortgage Credit Requirements. Investors often want notice and cure rights, and the right to bring in a "Special Limited Partner" quickly in case of default by or other failure of the initial General Partner. Provision of Notice to the Investor by HUD and pre-approval of a Special Limited Partner to step in and act as a General Partner for a limited period of time, under specific conditions, can be achieved through a "Rider to the Security Agreement for LIHTC Properties" available at [http://portal.hud.gov/hudportal/documents/huddoc?id=Security\\_Instrument\\_Rider.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=Security_Instrument_Rider.pdf). In addition, instructions for the use of this Rider are provided at [http://portal.hud.gov/hudportal/documents/huddoc?id=Pre-appr\\_Process\\_Instru.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=Pre-appr_Process_Instru.pdf). When passive partners are replaced however, a modified Transfer of Physical Assets ("TPA") may be required.

HUD's previous "LLC1 Form" has been replaced with the "Identification and Certification of Eligible Limited Liability Investor Entities", or "Passive Investor Certification", to better accommodate passive partners with limited liability. This form is used in place of the 2530 for such entities. The Passive Investor Certification may only be used by entities that are acting exclusively as passive investors, however, and it is not a substitute for any financial information that HUD may require to vet an investor's financial capacity. The form is available at the address below:

[http://portal.hud.gov/hudportal/documents/huddoc?id=Passive\\_Invest\\_Id\\_Certifi.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=Passive_Invest_Id_Certifi.pdf)

Both syndicators and investors may use the Passive Investor Certification in lieu of the 2530 or other Previous Participation Review submission. However, if a syndicator is creating a GP or LLC Managing Member or is otherwise related to the GP or Managing Member, the Previous Participation Review (currently, the Form - 2530 or APPS submission) will be required. Passive partners are generally described as participants who do not exercise day to day control. Typically, passive investors retain authority and responsibility only for occasional decisions such as approval of a change in

management agent, replacement of the GP in certain circumstances, and approval of capital improvement costs over a given dollar amount. These activities are not considered by HUD to be active day-to-day management, and accordingly upper tier investors with involvement limited to these or similar functions are not subject to Previous Participation Review clearance.

- C. Requirements for General Contractors: For Section 223(f) Tax Credit projects with Level 2 or Level 3 repairs, the General Contractor will not be treated as a principal unless it also has an ownership interest in the project. HUD will rely on other information with respect to the GC's experience described in a resume that must include 1) a discussion of relevant multifamily experience, 2) a schedule of jobs in progress, 3) the Form 2328, 4) the IOI certification, and 5) HUD's response to processing of the four questions on the 2013-SUPP Form. HUD or the lender may determine that greater detail is warranted, for example, in the case of a relatively inexperienced or undercapitalized borrower and/or a high cost rehab.

## **14.11 Identities of Interest in Tax Credit Transactions**

- A. Identity of Interest between the Lender and Syndicator. FHA allows an exception to its prohibition on identities of interest in certain cases, allowing MAP Lenders to retain interests of up to 25% in the tax credit equity of projects for which they are the FHA lender, with no limit on the number of projects. Supervised or publicly held MAP Lenders may request prior approval to hold up to 100% of the ownership in LIHTC limited partnerships or equivalent investor members in an LLC. See Section 2.7 for additional details.
- B. IOI Transfers for Non-Profits. Non-profit owners of currently insured or HUD-held properties may syndicate LIHTC properties and form new partnerships subject to HUD's Transfer of Physical Asset ("TPA") policies. (See Housing Notice 2011-31.)

## **14.12 Calculation of Mortgage Amounts for Tax Credit Projects**

- A. Section 223(f) applications for Tax Credit projects that involve transfers of ownership to identity of interest purchasers may be treated either as acquisitions or refinancing transactions for purposes of sizing the mortgage: Lenders may use either Criterion 7 or 10 on the HUD form 92264A.
- B. Underwriting Tax Abatements. If a purchase or refinancing transaction includes new or previously funded tax credit equity, the underwritten NOI may recognize tax abatements even if they run with the sponsorship (mortgagor) entity and not with the land. Procedures in Section 7.16 must be followed.

- C. **Substantial Rehab Contingency.** Generally, unspent contingency funds in an FHA-Insured loan project must go into a Reserve for Replacement Account (“R4R”) or pay down the mortgage. One exception to this rule applies to Low Income Housing Tax Credit properties with affordability restrictions that meet HUD’s definition of “Affordable Housing” and obtain FHA mortgages that are not sized with the use of the cost criterion. In such cases, HUD allows contingency funds included in the FHA mortgageable cost basis but not needed for repairs, appropriate betterments, or deposits to R4R, to be used to pay a developer’s fee (deferred or otherwise) or any other reasonable project related reimbursement item as defined by HUD. If contingency funds will not be used to reduce the mortgage, they should be placed into an escrow. Such funds should not be released until the later of Final Endorsement or 6 months of sustaining (breakeven) occupancy. Release of funds requires Satellite/Regional Office approval of project repairs, performance, and demonstrated compliance with all terms of the Tax Credit Program or other requirements of the applicable business agreements.

### **14.13 Developer Fees and GC Profit**

- A. Developer fees will be treated as mortgageable costs so long as they are 1) in amounts approved by the project’s LIHTC allocation agency and 2) scheduled for payment in amounts and at times agreed upon with the syndicator.

For FHA-insured loans limited to 80% of value, the loan to cost ratio provides a safe harbor and limits risk, so proceeds may be used for any purpose including payment of development fees higher than those described above. However when LTV is increased to a percentage of cost to finance under the Criterion 10 limits (90% or more for Section 8 LIHTC projects and 87.5% for unassisted LIHTC projects), payment of developer fees with FHA mortgage proceeds is limited to the amount approved as described above to the extent supported by the mortgage and consistent with all other allocating agency rules and the partnership or operating agreement. Developer fees cannot be claimed for projects for which BSPRA or SPRA is claimed, regardless of whether the developer fee is treated as a mortgageable cost or not. Developer Fees for different project types and loan programs are addressed in greater detail in Appendices 3.B.1. and 2.

- B. Neither BSPRA nor SPRA may be claimed when developers’ fees are included in the project budget, whether the developer fees are treated as mortgageable or not.
- C. **Relationship of Developer Fee to General Contractor Profit and Determination of Fees in Cases with an IOI Relationship between Contractor and Owner/Developer.** An IOI between the GC and the owner is allowed and does not require a waiver, but it must be disclosed in the application and may affect the fee structure. No blanket restriction has been imposed on the amount of General Contractor Profit, though it must be reasonable based on the market and the scope of work. Claiming both a GC profit and a developer fee when there is an IOI relationship between the two can result in excessive

compensation however. HUD generally relies on the policies of the State tax credit allocation agencies, which often scale fees down to lower limits when a single party or two related parties are receiving both the Developer Fee and the GC Profit. The Lenders' and HUD's Underwriters will evaluate the fees and profits for each project and reduce them if they are determined to be excessive, considering the scope of the project and the amount of the proposed fees. Projects with excessive fees may not be approved.

- D. Structuring of Deferred Developer Fee as Secondary Debt. Deferred developer fees may be treated as either secondary debt or equity. If treated as debt, the obligation must meet all private secondary debt requirements described in Part 14.14 below. Alternatively if the deferred developer fee is described in the partnership or operating agreement as an agreement between upper tier members, such that it is an obligation of one or more of the upper tier principals and will not encumber the project, it will be considered equity, not debt. Accordingly it need not meet the private secondary debt requirements.
- E. Payoff of Deferred Developer Fees in a Subsequent Transaction. When the FHA mortgage serves as a take-out source on a recently completed new construction or rehabilitation project, a deferred developer fee note from the most recent transaction (i.e. the construction closing) will be treated as originally structured. If the note is an obligation of one or more of the principals as described above, the deferred fee will be treated as equity, the cost of paying it off would not be mortgageable and the liability would have to be satisfied so as not to remain in place after the FHA loan closing. Alternatively if the note was structured as a debt of the ownership entity or project it may be recognized and paid off in the same manner as other debt, or assumed by the purchaser to remain in place after the refinancing. Because developer fees must be paid off for tax reasons within ten to twelve years in order to be treated as part of a project's eligible basis for Tax Credit purposes, the notes are not likely to be problematic in later refinancings such as those often done after year 15. Generally a deferred developer fee note will not be included in mortgageable costs basis, unless it is paid off through cash out in an 80% LTV transaction.

#### **14.14 Structuring of Secondary Debt in Tax Credit Transactions**

- A. LTV Ratio and Private Secondary Debt. For transactions that do not have Low Income Housing Tax Credits, Section 223(f) limits the combination of FHA insured and secondary financing to a loan to value limit of 92.5% (except when the debt source is a public entity). For tax credit (regardless of type) projects however, the debt limit can restrict property basis and tax credit amounts unnecessarily. Accordingly, HUD will not impose a loan to value limit on this secondary financing, regardless of the source. This means that in some cases debt will exceed value. However all such secondary debt is subject to the following conditions:

- 1) Payments on all secondary debt are restricted to 75% or less of the annual surplus cash, or from

the proceeds of a sale or refinancing of the property. (See 24 CFR 200.85(b).) This limit applies cumulatively to all secondary debt, private and public, to ensure that at least 25% of the surplus cash remains as an incentive to the owner. Owners may make additional payments on the debt out of their remaining 25% of cash flow, or from other sources.

- 2) The total combined private secondary debt does not exceed the limit of 100% of total project costs as confirmed by the HUD Underwriter's analysis of a comprehensive Source and Uses of Funds Statement. (Public secondary debt is not included in this calculation.);
- 3) The maturity date of the secondary debt must be coterminous with, or later than that of the first mortgage.
- 4) The secondary debt can reasonably be expected to be paid off over its term with 75% of the project's surplus cash;
- 5) The debt is documented in HUD's form of Surplus Cash Note (92223M) or subsequent version; or simple interest. However the lender should provide a thorough analysis demonstrating that project cash flow will be sufficient to avoid accruals of interest that would undermine the long term financial and physical integrity of the project, and all other risks have been adequately mitigated; and
- 6) Private debt of up to 100% of Total Project Costs may be secured with the project but it must be subject to automatic re-subordination in any refinancing of the first mortgage.

B. Bridge Loans. Temporary bridge loans are treated differently than other secondary financing, and are described in detail below in Part 14.16.

C. Publicly Funded Loans or Public Debt. Loans funded with HOME Funds or other federal, state or local public sources, as well as those funded by quasi-public agency programs such as the Federal Home Loan Bank's Affordable Housing Program (AHP), may be granted or lent directly to HUD's borrower, or to the GP or sponsor of the borrower, who will then loan it to HUD's borrower. All such sources will be treated as public secondary financing sources, and as such need not be included in the calculation of the 100% of total project cost limit applied to private secondary debt. However, none of these sources may be substituted for Tax Credit Equity required by the pay-in schedule provided below and all remain subject to the 75% cap on payments from surplus cash.

D. Deferred Developer Fees. Deferred developer fees are deducted from equity prior to the calculation of the required equity pay-in schedule. These fees may be converted to notes secured by the property and paid from surplus cash, but then they must be included as debt in the 100% of total project cost limit calculation. Deferred developer fees may also be treated as equity, in which case they are not secured

with the property and may be paid only through surplus cash. Further detail on developer fees in Tax Credit Projects is included in Section 14.13.

## 14.15 Tax Credit Equity Pay-In Schedule

FHA requires minimum Tax Credit equity contributions according to the following pay-in schedule for all LIHTC transactions<sup>6</sup> Filled in with actual total equity and net-equity amounts, the schedule is to be added as a special condition to the Firm Commitment for all Tax Credit Projects and used as a method of checking proposed disbursement schedules. Waivers of the first 20% equity pay-in will not be considered and neither bridge loans nor other sources, such as publicly funded loans or grants may be used to fund the first, 20% equity pay-in amount. Waivers of subsequent payment amounts will generally not be approved either.

<b>Benchmarks for Equity Installments</b>	<b>Minimum Equity Installment<sup>78</sup></b>
On Or Before Closing (223(f)) or Initial Endorsement (221(d)(4))	20% of Total Equity
At 65% Completion of Repairs (223(f)) or Construction Completion (221(d)(4))	37.5% of Net Equity
At 100% Completion of Repairs (223(f)) or Final Endorsement (221(d)(4))	62.5% of Net Equity

Equity investors may fund all or part of the required equity pay-ins defined above, with the exception of the first 20% payment, with equity bridge loans that meet the requirements described in Section 14.16 below. However, investors may not substitute any grant or loan funds, other than funds in the form of Equity Bridge Loans as described in Part 14.16 below, for the equity payments described in the chart above.

- A. Definition of “Net Equity”. The term “Net Equity” is equal to Total Equity less 1) Deferred Developer Fees that are documented in a note and paid from project surplus cash, not equity, 2) “Delayed” Developer Fees for amounts due after the completion of repairs or construction, but not included in the Deferred Developer Fee Note and 3) predetermined reserve amounts to be held by the investor for

<sup>6</sup> This schedule does not apply to equity derived from New Market or Historic tax credits.

<sup>7</sup> Additional equity is acceptable at each benchmark date shown, as well as at other interim dates at the investors’ discretion. However the amounts shown in this column are the minimum amounts required by any given benchmark date listed in the chart.

<sup>8</sup> With the exception of the first equity payment, which is calculated as a percentage of Total Equity, all percentages used in this column represent percentages of Net Equity. This includes equity going into the project as tax credit proceeds for both non-mortgageable and mortgageable costs. The Deferred Developer Fee must be documented in a note, and paid from the project’s surplus cash, not equity.

project uses after the time of the final pay in noted in the schedule above. Reserves allowed for this calculation may include only amounts that are required in the project’s Partnership Agreement or LLC Operating Agreement. These include Lease Up Fees and Escrows, Operating and Debt Service Reserves, Section 8 HAP Contract Transition Reserves, Replacement Reserves, and State Agency Administrative Fees or Escrows. When calculating the pay-in amounts, owners must first reduce the total amount of equity committed to the project by the amount of these costs, and apply the payment percentages above to the remaining or “Net” Equity. No other costs may be deferred. This calculation, specifying each applicable use, must be provided to HUD in the FHA insurance application.

B. An example of the calculation of the Net Equity amount, and the resultant pay-in schedule, is provided below:

**Total Equity or Gross Proceeds = \$7,500,000**

Net Equity = Total Equity Minus Allowed Reductions and Equity Pay In #1

Less Payment #1 \$1,500,000 (20% of Total Equity Above)

Remaining Equity \$6,000,000 (80% of Total Equity Above)

Less: Allowed Reductions Not to Exceed 25% of Total Equity (25% x \$7,500,000 = \$1,875,000)

Minimum Net Equity = \$7,500,000-\$1,500,000-\$1,875,000 =\$4,125,000

**Sample Owner’s Proposed Reductions:**

Delayed Developer Fee	\$500,000
Deferred Developer Fee	\$300,000
Lease Up Fees and Escrows	\$175,000
Operating Reserves	\$145,000
Debt Service Reserves	\$200,000
Section 8 HAP Contract Transition Reserves	\$235,000
Replacement Reserves	\$300,000
State Agency Administrative Fees or Escrows	\$45,000
 Total	 \$1,900,000

This total would be disallowed, as the \$1.9 million exceeds the 25% of total equity (\$1.875 million) allowed. Accordingly it is reduced by \$25,000 in the following calculations. Net Equity is the Balance, after Total Equity is reduced by Payment #1, and by the Allowed Reductions of \$1,875,000, or \$4,125,000. This number would be adjusted if the owner were to claim less than the maximum Allowed Reductions.

<b>Payment</b>	<b>Description</b>	<b>Formula</b>	<b>Amount</b>
Equity Pay I #1	20% of Total Equity	$20\% \times 7,500,000 =$	\$1,500,000
Equity Pay In #2	37.5% of Net Equity (\$4,125,000) (7,500,000- 1,500,000-1,875,000) =	$37.5\% \times \$4,125,000$	\$1,546,875
Equity Pay In #3	62.5% of Net Equity (\$4,125,000)	$62.5\% \times \$4,125,000$	\$2,578,125

## **14.16 Equity Bridge Loans (“EBLs”) in Tax Credit Projects**

Bridge loans may be used by Tax Credit investors to defer the pay-in of equity during a project’s development and stabilization phases, thereby increasing the return on equity. The bridge loan may be the obligation of one or more of the investors or other upper tier partners to the ownership entity (i.e. the limited or general partners), or an obligation of the project ownership entity/single-asset mortgagor itself. In addition the following conditions must be met:

- A. EBLs may not be secured by a lien on the real estate or on any other mortgaged property as defined in the Security Instrument, although they may be secured with a pledge of Tax Credits and/or of limited partners’ or investor members’ interests in the project’s ownership entity;
- B. EBLs must be non-recourse to the Borrower, and the bridge lender shall have no claim even in an event of default against the Borrower, the Project, FHA mortgage loan proceeds, or any reserve or deposit made with the FHA Lender, or otherwise required by HUD;
- C. In the event HUD acquires title to the Project by foreclosure or deed in lieu of foreclosure, the bridge loan documents automatically terminate and the Borrower shall be released of all of its obligations with respect to the EBL;
- D. The obligation must be evidenced by a promissory note; and
- E. The term of the note may last through the construction or rehabilitation period but must be paid in full no later than the following dates:

1. In the case of EBLs provided by private, for-profit lenders, at 100% Completion of Repairs for 223(f) loans, or at Final Endorsement for 221(d)(4) loans (the time of the final equity pay-in); and
  2. In the case of EBLs provided by not-for-profit, public sector or quasi-public sector entities, no later than ten (10) years following 100% Completion of Repairs for 223(f) loans, or Final Endorsement for 221(d)(4) loans.
- F. The borrower must provide evidence to the lender's satisfaction that the bridge loan has been paid in full at the times noted above; and
- G. At Firm Application, or as soon as the need for a bridge loan is known, the lender must submit a term sheet describing the key terms of the bridge loan, as well as a certification that a) the loan will be secured only by a pledge of partnership interests or tax credit benefits and not by the project, and b) that the bridge lender will have no claim against the mortgaged property, mortgage proceeds, any reserves or deposits, or against the rents or other income from the property for repayment of the bridge loan.
- H. Bridge loans for other purposes, (i.e. that are not used to advance equity in tax credit projects) are described in Chapter 8.

## **14.17 Syndicator and Investor Fees Paid from Operations**

Tax Credit projects often involve annual asset management related fees paid to the syndicator or an investor representative. HUD's Office of Asset Management and Portfolio Oversight allows usual and customary fees and expenses for operating a Tax Credit project, including payment of a syndicator's and/or investor's asset management fee, state allocation agency compliance and asset monitoring fees, and mandatory interest payments of up to one percent on subordinate debt provided by a government lender to be paid from the operating budget. Deferred developer fees, along with interest accrued at the Applicable Federal Rate for up to 12 years, may be included as an operating budget line item but may only be paid from surplus cash after the FHA-required reserves and first mortgage debt service are met. These fees are identified in the distributions "waterfall" of payments in the project's partnership agreement (or operating agreement, in the case of a Limited Liability Company.) If the expenses described above are included in the operating budget however, the loan must be sized accordingly by the lender, and the chosen treatment of the expenses must be documented in the closing documents. Fees paid with surplus cash, however, should not be included in the operating budget. HUD generally requires that at least 25% of surplus cash remains available as an owner incentive, though the remaining 75% may be obligated to payment of secondary debt.

Mark to Market Transactions: Owners are allowed to receive an Incentive Performance Fee (IPF), and this is paid before the 25%/75% split is calculated. Thus the IPF is paid first, and may be realized in addition

to the owner’s 25% of surplus cash. Mark to Market also obligates the owner to use the full 75% of surplus cash to pay down the program’s secondary M2M loans. Accordingly in M2M transactions, the payment of syndicators’ and investors’ fees must be limited to the 25% that is not committed for loan repayment.

### 14.18 Vacancy Rates

Vacancy rates used for loan sizing purposes (and generally as a guide for appraisers) are herein revised for all “Affordable” projects, to reflect differences in project types, as follows.

<i>Minimum Vacancy Rate</i>	<i>Property Type</i>
3%	<ul style="list-style-type: none"> <li>• HUD-assisted properties with Section 8 HAP contracts covering 90% or more of the units; or</li> <li>• In-place rehabs with 90% or greater occupancy for at least 6 months prior to the start of the rehab, 90% or more of the units LIHTC-restricted, and attainable tax credit rents at least 10% below comparable unit market rents (a 10% discount to market.).</li> </ul>
5%	<ul style="list-style-type: none"> <li>• Properties meeting at least the minimum LIHTC set-aside requirements (20% of the units set aside for tenants earning no more than 50% of median income, or 40% earning no more than 60%) and attainable tax credit rents at least 10% below comparable unit market rents (a 10% discount to market.)</li> </ul>
7%	<ul style="list-style-type: none"> <li>• Properties in which 100% of the units are LIHTC restricted, without a 10% discount to market; or</li> <li>• Properties in which more than 20% of the units are Market Rate and the remaining units are LIHTC restricted.</li> </ul>

### 14.19 Other Matters

A. The market study, appraisal and underwriting for all Tax Credit projects must address the relationship between the Tax Credit ceiling rents, the attainable rents, any subsidy contract rents and other terms, and true market rents. Any disparities among these rents, and their related risks, must also be addressed.

- B. HERA's Exception to the Tax Credit Program's 10 Year Holding Period. HERA provides for an exception to the LIHTC's ten year holding period requirement for certain federally assisted buildings, specifically those that are 221(d) or 236-insured. Because the HERA language refers to the two specific programs noted above as well as to "...any other program administered by the Department of Housing and Urban Development..." the waiver should apply to all FHA-insured tax credit projects. HUD does not render tax advice however so owners should seek tax counsel with respect to this interpretation.
- C. Bond financed projects in New York City. Section 42 of the IRS Code provides that for projects located in New York City, the "40-60" test (restricting 40% of the units for the use of tenants earning no more than 60% of median income) for determining whether a project qualifies as a low-income project, is replaced by a "25-60" test. Thus the affordability requirement is reduced from 40% to 25% of the units to be set aside at 60% of area median income. HUD will consider this exception to the set-aside on a case by case basis, when the lender's application demonstrates that the NYC market rents for the additional 15% unrestricted units that would otherwise have been restricted, will still provide for significant affordability in the local market.
- D. Lien Priority. The FHA mortgage lien is required by statute to be in first position ahead of all other financing. Restrictive covenants with no monetary obligations are not considered liens however, and in some instances it may facilitate a transaction if affordability use restrictions other than the Tax Credit LURA survives foreclosure and is recorded prior to the FHA mortgage. On a case-by-case basis HUD may approve non-monetary use restrictions that run with the land and thus may be superior in priority to HUD's first mortgage position. When waivers are requested the Lender must demonstrate and the HUD Underwriter must verify sufficient financial strength and strong mitigants to offset the risk of a negative impact on the marketability of the project in the event of a foreclosure or loan sale. Mitigants might include a low FHA loan to value or loan to cost ratio, significant amounts of public funds, high levels of funding by the source in question, Section 8 assistance for all of the units, and higher than minimum debt service coverage.
- E. Tax Credit Regulatory Agreements. In Tax Credit projects, certain IRS Section 42 obligations must be allowed to continue post-default. Generally, however, for the Tax Credit LURA, and/or when public secondary financing with regulatory agreements or restrictive covenants are required, HUD requires the use of its standardized rider to these restrictive covenants, indicating that in case of conflicts between a LURA or another restrictive covenant and FHA "program obligations," FHA requirements take precedence. Neither this provision nor the use of the rider itself should be waived. Instead, staff must identify the point of conflict and consult with OGC. Alterations of the rider that are once approved can then be used as the template for that jurisdiction, as applicable. Typical conflicts include differing numbers of units set aside for particular income levels, different use agreement termination dates, etc. It is the lender's responsibility to draw attention to potential conflicts between FHA requirements and the LURAs or other restrictive covenants as early as possible (i.e., during

Concept Meetings) and no later than with Firm Commitment application submission. If they are not addressed in the Firm Commitment, the lender should assume the closing will be delayed.

- F. Tax Exempt Bonds/Take out by FHA Insured Permanent Debt. Tax Credit projects are often financed with the "4%" Tax Credits allocated in conjunction with private activity bond volume cap, rather than the "9%" Tax Credits competitively allocated by State Agencies. Taxable Ginnie Mae securities' yields and the resulting rates on FHA multifamily loans at times can be lower than tax exempt bonds and municipal bond-backed multifamily loan rates. Consequently, investment banks have developed an approach that combines taxable Ginnie Mae securities with short term, tax exempt bonds and 4% LIHTC. This structure establishes several different account funds, along with a series of cash flow events between the various accounts upon a draw request. The tax exempt bonds are secured by cash collateral initially provided by the FHA lender's warehouse funds (or other funding source, but not FHA-insured loan proceeds), which in turn are reimbursed with proceeds from the sale of Ginnie Mae-guaranteed securities. The tax exempt bonds are retired with the proceeds of the bond collateral account when the project is placed into service.

This structure allows the borrower to avoid higher loan rates that exist when the loan funding source consists exclusively of tax exempt bonds, and still take advantage of the 4% LIHTC equity. This bond financing structure is generally acceptable to HUD, but each transaction must be reviewed by Housing field staff and OGC field counsel for programmatic and legal sufficiency, including the review of specific transaction documents. Accordingly, underwriters must involve their OGC counterparts early in the process to ensure these issues are addressed early and do not constrain the transaction's processing.

Note that FHA-insured loan proceeds shall not be used to serve as collateral for the bonds, and they may not be paid to the bond trustee or sent to other accounts to facilitate issuance of the bonds. This is a statutory prohibition that may not be waived, as FHA-insured loan proceeds are only permitted to directly finance the relevant activity authorized under the applicable section of the National Housing Act. To ensure statutory compliance regarding the use of FHA-insured loan proceeds, HUD OGC requires lenders to sign and submit the "Lender Certification for Tax Exempt Bond and 4% Low Income Housing Tax Credit Transactions" for financings structured in this manner.

- G. Refinancing of M2M Properties. HUD's Office of Recapitalization, along with the field offices' Asset management staff, are responsible for reviewing any transactions that have been through an M2M restructuring. Those transactions require a waiver of the "due on sale..." clause and extension of the maturity dates of all subordinate notes originated in the restructuring. Current guidance is in Notice H 2012-10, and it explains when the field offices can process the waivers, and when HQs must do it. In complex Tax Credit transactions requiring subordination of M2M debt, the owner or lender must request the waiver as early as possible to avoid delays, especially in the case of Tax Credit Pilot transactions. FHA Production staff may also be involved to ensure that the Recapitalization office's

conclusions are consistent with the underwriting of the project.

- H. Underwriting 20 year Section 8 NOI for LIHTC projects may result in the use of loans structured in two tranches, as described in Part 7.8.H.3.

## **14.20      FHA Tax Credit Pilot Program Expansion**

Expansion of the FHA Tax Credit Pilot Program to include new construction and substantial rehabilitation projects is forthcoming in future guidance.

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# Chapter 15

## Quality Assurance

### Enforcement Actions

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#### 15.1 Oversight of Map Lenders

By permitting a MAP Lender to prepare much of the documentation for a loan submission for mortgage insurance, HUD places confidence in the lender's integrity and competence. HUD and MAP Lenders have a mutual interest in ensuring consistent lender competence and compliance with the MAP Guide and other relevant guidance and handbooks. If in the process of performing this work, the lender places HUD at un-due risk, HUD will issue a Warning Letter or sanction the lender.

Every HUD multifamily employee plays an important role in the MAP Quality Assurance (QA) effort. This Chapter provides QA guidance to Program Centers, Hubs, and the Office of Multifamily Production (OMP) Headquarters, including the Office of Counterparty Risk Management (CRM). Such quality assurance tools are: i) Warning Letters; ii) Probation; iii) Suspension; iv) Termination; v) Limited Denial of Participation (LDP); and vi) referral to the Mortgagee Review Board or the Office of Inspector General. An LDP is a sanction applied to participants in loan transactions other than FHA-insured lenders under procedures set forth in 24 CFR § 2424 Subpart J. The purpose and authority of the Mortgagee Review Board is set forth in 24 CFR Part 25. This Chapter of the MAP Guide implements 24 CFR part 200, Subpart Y.

#### 15.2 Authority to Issue MAP Sanctions

##### A. General.

1. At any time, a Hub/PC Director, the Director of the Office of Multifamily Housing Production (OMP) Headquarters, or the Director of Multifamily Asset and Counterparty Oversight Division (MACOD) may initiate discussions with a MAP Lender regarding any concerns HUD has with respect to any of the lender's actions or personnel, or any changes the lender should make in using its MAP authority.
2. If there are concerns about the lender's underwriting and/or construction loan administration, a Hub/PC Director, the Director of OMP or the Director of MACOD may take certain actions detailed below.
3. Every HUD multifamily employee must refer any possible instances of fraud, material misrepresentation or other criminal violations to the Office of the Inspector General.

- B. A Program Center Director may:
1. Recommend to the Hub Director that s/he recommend to the Director of MACOD the Probation, Suspension or Termination of a MAP Lender.
  2. Initiate the issuance of a LDP of an individual or a firm involved in a “covered transaction” as defined in 2 CFR 2424.220.
- C. A Regional Director may:
1. Recommend to the Director of OMP or MACOD the issuance of an LDP to an individual or firm involved in a “covered transaction” as defined in 2 CFR 2424.220.
  2. Recommend to the Director of OMP or MACOD that the MAP Lender be referred to the MAP Lender Review Board for possible Probation, Suspension or Termination.
- D. The Director of OMP or MACOD may:
1. Refer an individual or a firm involved in a “covered transaction,” as defined in 2 CFR 2424.220 to Headquarters’ Deputy Assistant Secretary (DAS) for Multifamily Housing for imposition of an LDP, which may be imposed nationwide or on a more geographically restricted basis.
  2. Refer the MAP Lender to the MAP Lender Review Board for possible Probation, Suspension or Termination.
  3. Issue a Warning letter.
- E. The DAS for the Office of Multifamily Housing Programs may:
1. Issue a Warning Letter.
  2. Refer the MAP Lender to the MAP Lender Review Board.
  3. Refer the MAP Lender to the Office of Inspector General.
- F. All recommendations authorized in Sections 15.2B through E shall be in writing, and shall state the reasons for the recommendations and the supporting facts. Recommendations for an enforcement action shall be transmitted to the next higher level of review, as set forth above, together with copies of all supporting documents.

### **15.3 Basis for issuing a Warning Letter or Sanctioning a MAP Lender**

A MAP Lender’s improper, inaccurate or inadequate underwriting and construction loan administration may lead to a Warning Letter or other sanction from HUD. Examples include, *but are not limited to*, the following:

- A. Minor offenses that may be the basis for a Warning Letter include:
1. Failure to provide required exhibits or the submission of incomplete or inaccurate exhibits. Although the MAP Lender will be permitted to correct minor errors or provide additional information, substantial inaccuracies or lack of significant information will result in return of the application and retention of any fees collected.

2. Repeated failure to complete processing to Firm Commitment unrelated to the project underwriting analysis.
  3. Preparation of an underwriting Narrative Summary that is not supported by the appropriate documentation and analysis.
  4. Failure to notify the HUD processing office promptly of changes in the mortgage loan application for a Firm Commitment that has been submitted, such as changes in rents, numbers of units or gross project area.
  5. Failure to meet MAP closing requirements or construction loan administration requirements.
  6. Business practices that do not conform to those generally adopted by prudent lenders or that show irresponsibility.
  7. Failure to cooperate with an MACOD review.
- B. Serious offenses that might be the basis for a Warning Letter, Probation, Suspension, or Termination include:
1. Receipt of multiple Warning Letters over any one-year period. In determining which sanctions to pursue as a result of prior warning letters, HUD will consider the circumstances surrounding those warning letters and any corrective actions undertaken by the lender.
  2. Fraud or material misrepresentation in the lender's participation in FHA multifamily programs.
  3. Lender collusion with or influence upon third party contractors to modify reports prepared by the contractor that affect the contractor's independent evaluation.
  4. A violation of MAP procedures by a third party contractor, which the MAP Lender knew, or should have known, was occurring and which, if performed by the MAP Lender itself, would constitute a ground for a sanction under this chapter.
  5. Evidence that a lender's improper, inadequate or inaccurate underwriting was a cause for assignment of an insured mortgage.
  6. Identity-of-interest violations under Section 2.7 of this Guide.
  7. Payment by or receipt of a payment by a MAP Lender of any kickback or other consideration, directly or indirectly from the sponsor or from any other participant in the transaction, which would affect the lender's independent evaluation, or represent a conflict of interest, in connection with any insured mortgage transaction.
  8. Failure to comply with any agreement, certification, undertaking, or condition of approval listed in a MAP Lender's application for approval.
  9. Noncompliance with any requirement or directive of the Director of OMP or MACOD.
  10. Violation of the requirements of any contract with HUD or violation of the requirements in any statute, regulation, handbook, notice, mortgagee letter, or other written rule or instruction including the MAP Guide as interpreted by answers to Frequently Asked Questions (FAQ's) that are posted on the MAP website.

11. Submission of false information or a false certification to HUD in connection with any MAP mortgage transaction.
12. Failure of a MAP Lender to respond in a timely manner to inquiries from the Director, OMP or MACOD in accordance with this Chapter.
13. Indictment or conviction of a MAP Lender or any of its officers, directors, principals or employees for an offense that reflects on the responsibility, integrity or ability of the lender to participate in MAP.
14. Employing or retaining an officer, partner, director or principal at the time when the person was suspended, debarred, ineligible or subject to a LDP, or otherwise prohibited from participation in HUD programs, when the MAP Lender knew or should have known of the prohibition.
15. Employing or retaining an employee who is not an officer, partner, director or principal, and who is or will be working on HUD-FHA program matters, at a time when that person was suspended, debarred, ineligible, or subject to a LDP or otherwise prohibited from participation in HUD programs, when the MAP Lender knew or should have known of the prohibition.
16. Failure to cooperate with an audit or investigation by the HUD Office of Inspector General or an inquiry by HUD into the conduct of the MAP Lender.
17. Failure to fund insured mortgage loans or any misuse of mortgage loan proceeds.

C. The issuance of a Warning Letter is not a prerequisite to the Probation, Suspension or Termination of a lender's MAP privileges.

## **15.4 Administrative Record**

When any final action is taken against a MAP Lender, an administrative record must be prepared which includes all materials that may have influenced the decision and not merely those relied upon in the final decision. Although not intended to be an exhaustive listing, examples of material that should be included in the record are:

- Correspondence between the lender and HUD or the lender and any third party contractors;
- E-mails, if relied on in the decision process;
- Fax's including the FAX cover sheet and the FAX confirmation sheet;
- Application and underwriting submissions;
- Copies of appropriate sections of notices, guide books including FAQ's posted on the Multifamily web site, handbooks, regulations and statutes;
- Notes from meetings and telephone conversations; and

- Work product and recommendations from subordinates.

The term “final action” includes issuance of a Warning Letter but does not include any referral, recommendation for action, or presentation to the Director of OMP or MACOD. In matters before the Director of OMP or MACOD, the administrative record ordinarily will consist of the referral and the materials accompanying the referral, any written materials submitted by the lender and any written materials submitted by the Director of OMP or MACOD in response to those materials, the transcript of the informal meeting when that transcript is a part of the record, and the final decision of the Director.

***NOTE: Intra-agency memoranda and other such records should be included, but will not be released if privileged. The administrative record in its final form as described in this Section relates to and supports HUD’s final action and is not to be released to any person outside of HUD until it has been reviewed by the Office of General Counsel. All evidentiary material supporting any recommendation to the MAP Lender Review Board must be delivered to the lender as provided in Section 15.13.A and must be included in the administrative record.***

## **15.5 Warning Letters**

- A. The Director of OMP, MACOD and the DAS may issue a Warning Letter to a MAP Lender.
- B. The Warning Letter:
  1. May require a meeting in the official’s office with principal owners of, and/or Officers of the MAP Lender to discuss the problem(s) and possible corrective action(s).
  2. Shall specify the violation(s) for which the Warning Letter is issued. If the Warning Letter explains or interprets a section of the MAP Guide, the text of the letter (after deleting all information that might identify the MAP Lender concerned) shall be posted on the Multifamily MAP web site as a FAQ.
  3. Direct the taking of a corrective action.
- C. The Warning Letter does not suspend a lender’s MAP privileges but may impose a higher level of review of the lender’s underwriting by the Hub/PC and/or Headquarters.
- D. The Warning Letter must clearly state that it is a Warning Letter issued pursuant to this Chapter. The letter will be mailed to:
  1. The MAP Lender’s contact person as listed on the MAP website.
  2. The Director of MACOD, along with a copy of the administrative record.
- E. The lender may request a copy of the administrative record prepared with respect to a Warning Letter.

## 15.6 MAP Probation

Only the MAP Lender Review Board may place a lender on probation. Probation is intended to be corrective in nature and not punitive. As a result, release from probation is conditioned upon the lender meeting a specific requirement or requirements, such as replacement of a staff member.

A. During the probation period a MAP Lender may:

1. Not submit, and the Hub/PC may not accept, materials after the close of business of the date of the probation letter, for a new:
  - a. MAP Pre-application for a Section 220 or 221(d) project involving new construction, substantial rehabilitation; or
  - b. MAP Firm Commitment application for a Section 223(a)(7) loan or an application for Section 207 pursuant to Section 223(f) project involving a purchase or refinance.

**NOTE:** If either a new Pre-application or a new Firm Commitment application for a Section 207 pursuant to Section 223(f) was accepted after the date of the probation letter, it must be returned to the MAP Lender.

2. Continue to process any:

- a. MAP Section 220 or 221(d) project involving new construction/substantial rehabilitation when a pre-application was submitted to a Hub/Program Center before the date of the probation letter.
- b. MAP Section 207 (pursuant to Section 223(f) project involving purchase or refinance when a Firm Commitment application was submitted to a Hub/Program Center before the date of the probation letter.

B. Probation continues until all corrective actions required by the OMP or MAP Lender Review Board (for example, exclusion of a specific staff member from work on MAP loans) are taken by the MAP Lender. When all corrective actions have been taken, the MAP Lender shall notify the OMP. Once the OMP is satisfied that the corrective actions have occurred, the Probation period shall end. A false statement that corrective action has been taken constitutes a false certification as described under Section 15.3, and may constitute a violation of 18 U.S.C. § 1001. A lender's failure to take prompt corrective action after Probation has become final may be the basis for Suspension or Termination.

C. Probation is in effect nationwide and the lender's name shall be removed from the MAP-Approved Lender list on the web. When Probation is lifted, the lender's name shall be re-posted.

D. The Notice of Action placing a lender on probation will be:

1. Sent by overnight delivery;

2. Addressed to the MAP Lender's contact person as listed on the Multifamily MAP website; and
  3. Signed for by an employee of the MAP Lender upon receipt.
- E. Refer to Section 15.12 and 15.13 for sanction and notice procedures.

## **15.7 MAP Suspension**

Only the MAP Lender Review Board may suspend a lender's MAP eligibility.

Suspension will not exceed 12 months except when special conditions are imposed. If both a time limit and conditions are imposed, suspension will terminate only when the time period has expired, the MAP Lender has submitted a certification of compliance with the conditions to the Board and the Board has notified the lender it is satisfied that the corrective actions have occurred.

A. During the suspension period a MAP Lender may not:

1. Submit application materials after the close of business of the date of the suspension letter for a new:
  - a. Pre-application for a Section 220 or 221(d) project involving new construction/substantial rehabilitation; or
  - b. MAP Firm Commitment application for a Section 223(a)(7) loan or an application for Section 207 pursuant to Section 223(f) project involving a purchase or refinance.

If either a new Pre-application or a new Firm Commitment application for a Section 207 pursuant to Section 223(f) was accepted after the date of the suspension letter, it shall be returned to the MAP Lender.

2. Continue to process any:
  - a. Section 220, or 221(d) project involving new construction/substantial rehabilitation when a pre-application was submitted to a Hub/Program Center before the date of the suspension letter.
  - b. Section 207 pursuant to Section 223(f) project involving purchase or refinance when a Firm Commitment application was submitted to a Hub/Program Center before the date of the suspension letter.

B. The Notice of Action placing a lender on Suspension will be:

- Sent by overnight delivery;
- Addressed to the MAP Lender's contact person as listed on the Multifamily MAP website; and
- Signed for by an employee of the MAP Lender upon receipt.

- C. Suspension is in effect nationwide and the lender's name shall be removed from the MAP-Approved Lender list on the web. When Suspension is lifted, the lender's name shall be re-posted.
- D. Refer to Sections 15.12 and 15.13 below for sanction and notice procedures.

## **15.8 MAP Termination**

Only the MAP Lender Review Board may terminate a lender's eligibility for MAP.

- A. A terminated lender may not submit, and the Hub/PC may not accept, materials after the close of business of the date of the termination letter for a new:
  - 1. Pre-application for a Section 220 or 221(d) project involving new construction/substantial rehabilitation; or
  - 2. MAP Firm Commitment application for a Section 223(a)(7) loan or an application for Section 207 pursuant to Section 223(f) project involving a purchase or refinance.
- B. Any MAP pre-application or MAP application in process may no longer be processed by the terminated lender. The lender will either:
  - 1. Immediately transfer the transaction to the TAP procedure and the Hub/PC will completely reprocess all stages of the transaction; or
  - 2. Immediately transfer the project to a new MAP Lender. The new MAP Lender must completely reprocess all stages of the transaction. At no time may the new MAP Lender assign the Pre-application, the firm application, the mortgage insurance commitment, or the insured construction loan back to the original MAP Lender.
- C. The Department will not endorse any MAP loan processed by the terminated lender unless a Firm Commitment was issued before the date of termination.
  - 1. Firm Commitments involving new construction or substantial rehabilitation must be immediately

transferred to a new MAP Lender. At no time may the new MAP Lender assign the Firm Commitment, or the insured construction loan, back to the original MAP Lender.

2. Firm Commitments issued for Section 223(f) projects may be transferred before final endorsement to any approved MAP Lender or kept in the lender's portfolio.
  3. For those construction loans that have been initially endorsed, the MAP Lender will lose its MAP privileges for construction loan administration. HUD will assume all the construction loan administration duties as it normally performs for TAP processing.
- D. The original lender may not service a transferred loan once it is finally endorsed.
- E. An application for reinstatement of MAP authority may not be made for 12 months after the date of termination. The requirements for reinstatement shall be the same as for initial qualification and the applicant must show that the problems, which led to termination, have been resolved.
- F. The Notice of Action terminating a lender will be:
1. Sent by overnight delivery;
  2. Addressed to the MAP Lender's contact person as listed on the Multifamily MAP website; and
  3. Signed for by an employee of the MAP Lender upon receipt.
- G. Termination is in effect nationwide and the lender's name shall be removed from the MAP-Approved Lender list on the web.
- H. Refer to Sections 15.12 and 15.13 below for sanction and notice procedures.

## **15.9 Settlement Agreements**

- A. The Director of OMP and MACOD is authorized on behalf of the Office of Multifamily Housing to negotiate settlement agreements with MAP Lenders.
1. **Before** the Director of OMP or MACOD has recommended a MAP Lender to the MAP Lender Review Board for possible Suspension or Termination, the DAS for Multifamily Housing or his/her designee must approve any proposed settlement agreement.
  2. Settlement negotiations may occur before or after the issuance of a warning letter. Prior to referral of the action to the Board, the DAS is authorized to approve a settlement agreement. Once an action is referred to the MAP Lender Review Board, only the Board may approve the settlement agreement.

- B. Settlement agreements may provide for:
1. Cessation of any violation.
  2. Correction or mitigation of the effects of any violation.
  3. Removal of lender staff from positions involving origination, underwriting and/or construction loan administration.
  4. Actions to collect monies wrongfully paid by the MAP Lender to a third party.
  5. Implementing or revision of a Quality Control Plan or other corrective measure acceptable to HUD.
  6. Modification of the duration or provisions of any administrative sanctions HUD deems appropriate.
- C. A MAP Lender's compliance with a settlement agreement is evidenced by certifying its compliance with the conditions of the agreement and by HUD determining that the lender is in compliance with the conditions of the agreement.
- D. Failure by a MAP Lender to comply with a settlement agreement may result in referral to the MAP Lender Review Board or the Mortgage Review Board for probation, suspension or termination.

## **15.10 MAP Lender Review Board**

- A. The Board is authorized to take action against any MAP Lender that violates MAP requirements.
- B. Composition.
1. The Board shall consist of three Multifamily Housing Officials designated by the DAS for Multifamily Housing.
  2. Board Members.
    - a. Are selected from among Hub and Program Center Directors or Multifamily Housing employees.
    - b. May serve on a continuing basis or may be chosen for the particular review, as the DAS determines.
    - c. Shall have no prior business affiliation or other conflicts of interest with the lender under review.
    - d. Shall select one of their members to act as Chairman of the MAP Lender Review Board.
    - e. Are expected to have knowledge of multifamily housing origination, underwriting and construction loan administration procedures.
  3. The following individuals cannot serve on the Board:

- a. The Hub/Program Center Director making the recommendation;
  - b. Staff from the Hub/Program Center making the recommendation;
  - c. The Director of OMP or MACOD; and
  - d. Staff from OMP and MACOD
- C. Non-voting Advisors to the Board.
- 1. Designee of the Office of Inspector General
  - 2. Designee of the Office of General Counsel
- D. The Director of OMP or MACOD or his/her designee presents the cases to the MAP Lender Review Board
- E. Functions, Duties and Powers.
- 1. The MAP Lender Review Board is authorized to impose appropriate sanctions on a MAP Lender after:
    - a. Conducting an impartial review of all information and documentation submitted to the board; and
    - b. Making factual determinations that there has been a violation of MAP requirements.
  - 2. In determining what action is appropriate, the Board will consider among other factors:
    - a. The seriousness and extent of the violation(s);
    - b. Any history of prior offenses;
    - c. Deterrence of future violations;
    - d. Any inappropriate benefits received by the MAP Lender;
    - e. Potential inappropriate benefit to other persons; and
    - f. Any mitigating factors.
  - 3. The Board may refer:
    - a. A MAP Lender to:
      - (1) The Mortgagee Review Board for possible termination as a HUD-FHA approved mortgagee or lender, and/or imposition of civil money penalties for knowing and material violations of HUD-FHA requirements (see Section 15.17)
      - (2) The Office of Inspector General
    - b. An individual or firm involved in a “covered transaction,” as defined in 2 CFR 2424.220 to the DAS for imposition of an LDP which may be imposed on a nationwide basis or on a more restricted geographic basis.

## **15.11 Support Staff for MAP Lender Review Board**

- A. The Chairman of the Board supplies the clerical staff for the MAP Lender Review Board. The clerical staff:
1. Coordinates Board activities with other HUD offices and government agencies.
  2. Develops the agenda and policy issues for Board meetings.
  3. Notifies a MAP Lender of any sanction imposed by the Board.
  4. Notifies a MAP Lender, when the Board is to consider sanctions.
  5. Keeps the official minutes of the Board and the case files and all Board actions.
  6. Drafts all notices, orders, letters, and directives on behalf of the Board.
  7. Performs other duties assigned by the Chairman or as directed by the Board.
- B. The Director of OMP or MACOD or his/her designee serves as the prosecutor and:
1. Are the contacts on all matters concerning the Board.
  2. Presents the sanction cases to the Board.
  3. Collects, analyzes, prepares and submits to the Board the charging document and supporting documentation together with possible options or recommendations as to sanctions against a MAP Lender.
  4. Refers cases for Board consideration.
  5. Negotiates settlement agreements with MAP Lenders.
  6. Prepares the administrative record of all matters before the Board.
- C. Office of Inspector General
1. Refers MAP Lenders for Board consideration as a result of audits or investigations.
  2. Performs audits or investigations of approved MAP Lenders.
- D. Office of General Counsel.
1. Advises the Board as to the legal sufficiency of actions it proposes to take.
  2. Assists the Board in the drafting of Board decisions and orders.
  3. Assists the Director of OMP or MACOD in settlement negotiations.
  4. Provides other legal advice as requested by the Board.

## **15.12 Procedures for Sanctions**

- A. Requests for MAP Lender Review Board Action. The Director of OMP or MACOD, or his/her designee, may refer a MAP Lender to the Board for consideration of sanctions.
1. Any referral from a Hub Director must be sent to the Director of OMP or MACOD.
  2. The referral must contain a written report, which includes:

- a. A full factual background description of the violations;
  - b. Specific citations of the Department's requirements that have been violated; and
  - c. All available supporting documentation that bears upon the violations (the administrative record discussed earlier)
3. There is no notification to the lender until the Board is constituted and receives the charging documents from the Director of OMP or MACOD. (At that point, notification under Section 15.13 is automatic, and does not require substantive consideration by the Board of the nature of the charge.)

B. Appointment of the Board.

When the Director of OMP or MACOD intends to send a referral to the MAP Lender Review Board, s/he requests the DAS to appoint a Board, as described in Section 15.10.

C. Initial Consideration by the Board.

When the Board receives a referral from the Director of OMP, the Board members may confer by email or by conference calls or in person. Any record of confidential communications between and among Board members at this stage of the proceedings is privileged from disclosure and will not be part of the administrative record of any matter.

D. Informal Conference.

1. The lender may request an informal conference as discussed in Section 15.13, which the Board will schedule.

2. After notifying the lender and permitting the lender an opportunity to respond, the Board will meet with the lender or its designees and with the Director of OMP and his/her designees to review documentary evidence and presentations by both sides (see Section 15.13).

a. Transcript of the informal meeting.

(1) No transcript of this informal meeting will be made, unless the lender elects to have a transcript made by a certified court reporter at its own expense. If the lender elects to have a transcript made, it must provide three copies of the transcript to HUD within five business days of the informal meeting. The transcript will not become a part of the record unless it is submitted within the 5-day time frame.

(2) If a transcript is not provided within the time limit set forth above, oral statements made at the informal meeting will not be considered as part of the record, except that the Board may consider voluntary admissions, made by a representative of the lender, of any element of the violation charged.

b. Any additional documents, evidence, or written arguments, which the lender wishes to present to the Board, must be presented within five working days after this informal meeting.

E. Action by the Board.

1. Upon consideration of evidence submitted by the Director of OMP or MACOD and the MAP Lender, the Board will confer and make a final decision regarding the matter.

2. Any final decision by the MAP Lender Review Board placing a lender on Probation, or Suspension, or Terminating a lender shall be in writing and shall state the reasons for the decision and the facts supporting those reasons. Higher level officials and decision makers, including the MAP Lender Review Board, are not bound by the recommendations from other HUD officials described above, except that the Board may not take any action against a lender which is more severe than the action recommended by the Director, OMP or MACOD. In any case where the action taken or the recommendation made differs from the recommendation received, that difference shall be explained in writing.

F. Effective Date of Action.

Unless the Board decrees that a later date should apply, any sanction (probation, suspension or termination) shall become effective on the date of the Notice of Action to the lender.

- G. The lender may appeal the Board's decision to the DAS for Multifamily Housing or his/her designee, as specified in Section 15.15.

### **15.13 Notice of Violation**

- A. Before the MAP Lender Review Board reviews a matter for consideration of a sanction, the Board's Chairman will issue written notice of the proposed action to the MAP Lender's contact person as listed on the Multifamily MAP web site. The notice is sent by overnight delivery and must be signed for by an employee of the MAP Lender upon receipt. The notice:
1. Informs the lender that the Board is considering a specific violation.
  2. States the specific alleged factual violations with citation to the Department's requirements that have been violated.
  3. Includes as attachments copies of all documents evidencing the violation or upon which the Board will be asked to rely in reaching a decision.
  4. Provides the lender with the opportunity, within 15 business days from the date of the issuance of the proposed action, to:
    - a. Meet informally with the Board in person or by video conference using HUD facilities at Headquarters or one of the various Hub/PCs; and/or
    - b. Present written evidence and any other relevant information.
  5. Offers the MAP Lender the opportunity to reply in writing to the Board within 15 business days from the date of the issuance of the proposed action. Failure to reply may result in a determination by the Board without considering the MAP Lender's comments.

6. Requires the response to be addressed to the Chairman of the Board. The response may not exceed 15 double-spaced typewritten pages and must include an executive summary, a statement of the facts, an argument and a conclusion. All written material and supporting documentation must be submitted in triplicate.

Accompanying the notice of violation is a copy of the charging document and all of the supporting documentation that has been submitted to the Board.

- B. The MAP Lender Review Board has the power to issue a Notice of Action discussed in Section 15.14 to terminate a lender, or to place a lender on probation or suspension without advance notice to the lender when there is an imminent need to protect the financial interests of the Government. No such action shall be taken except upon the written recommendation of the Director of OMP and approval of the DAS for the Office of Multifamily Housing Programs upon a determination by the Board that immediate action is necessary. In every such case, the lender shall be promptly notified of the Board's decision and the reasons for it, and shall have the right to submit materials to the Board and appear before the Board to seek a prompt reconsideration of the Board's decision.

## **15.14 Notice of Action**

- A. A prompt decision is important when a MAP Lender has been placed on probation. The decision will be communicated within 10 business days of the receipt of the lender's information and/or the informal conference.
- B. The OMP or MACOD will notify the MAP Lender of its final determination by overnight delivery of a written notice of the final decision to the MAP Lender's contact person as listed on the Multifamily MAP web site.
- C. The final decision will:
  1. State the nature and duration of the action.
  2. State the violations and any factual findings.
  3. Inform the MAP Lender of its right to an appeal conference.
  4. May add or modify the reasons for the decision as stated in the notice.
- D. A copy of the administrative record will be sent to the lender by overnight express within one business day after the issuance of the final decision.

## 15.15 Appeals

### A. Appeal Conference.

1. Whenever HUD imposes a sanction of probation, suspension or termination against a MAP Lender, the lender may, within 10 business days of receiving the sanction letter, request in writing, an appeal conference before the appeals official. The Appeals Official must be an individual who has not previously been involved with the proceedings or settlement discussions up to this point.
2. No transcript of the appeal conference-will be made, unless the lender elects to have a transcript made by a certified court reporter at its own expense. If the lender elects to have a transcript made, it must provide three copies of the transcript to HUD within five business days of the informal meeting.
3. Oral statements made by any participant at this meeting are not considered as evidence on any matter under consideration, except that the Appeals Official may consider voluntary admissions by a representative of the lender of any element of the violation charged.
4. Any additional written arguments, which the lender wishes to present to the Appeals Official, must be presented within five business days after the date of the appeal conference.
5. While the appeal is pending, the notice of action is in effect.

### B. The appeal conference regarding the Board's action will be held within 10 business days of HUD receiving the MAP Lender's appeal request.

1. The Director of OMP provides the administrative record to the Appeals Official and points out the evidence on which the decision was made; and
2. The MAP Lender may provide oral arguments in support of its position and the evidence previously submitted. No new evidence may be submitted to the Appeals Official at this point.

### C. A MAP Lender may voluntarily request and the Appeals Official may agree to have an appeal conference held more than 10 but not more than 30 business days after the date of the lender's request for an appeal.

### D. Within 10 business days after the date of the appeal conference, or the expiration of the period allowed for the submission of documents and written arguments, whichever is later, the Appeals Official makes a written determination. S/he may confirm, modify, or overturn the MAP Lender Review Board's decision. The Appeals Official shall include in his or her written determination the reasons for confirming, modifying, or overturning the Board's decision.

- E. If the MAP Lender does not request a conference within 10 business days of receiving the sanction letter, the right to a conference will be considered waived.
- F. If the Appeals Official overturns the MAP Lender Review Board's decision, the lender shall immediately return to an active status as a MAP Lender. The active status of the MAP Lender will be posted on the HUD web.
- G. Participation in the appeal process is not a prerequisite to filing of an action for judicial review under the Administrative Procedure Act.

## **15.16 Limited Denial of Participation**

The criteria and procedures in this section apply to suspensions and debarments as well as to limited denials of participation. See Chapter 4 of OGC Handbook 1300.13 REV 1, Debarment, Suspension, and Ineligibility of Participants and Contractors, and HUD Regulations at 2 CFR 2424. In case of any conflict between this section and the foregoing authorities, those authorities control.

- A. An LDP may be imposed upon any participant or contractor and its affiliates, except HUD-FHA approved mortgagees. Examples of participants that may be sanctioned are (but are not limited to):
  - 1. Independent Fee Appraisers
  - 2. Third Party Cost Analysts
  - 3. Needs Assessors
  - 4. Environmental Analysts and Engineers
  - 5. General Contractors
  - 6. Architects
  - 7. Specific underwriters or loan analysts
  - 8. Application Sponsors
- B. Once issued, the LDP may apply to any contractor, participant or to a participating organization. For example, a specific appraiser may be issued a LDP, or an entire appraisal firm may be issued a LDP. A LDP may also apply to all affiliates of that contractor or participant at the discretion of the imposing official.
- C. Conditions Warranting Referral to HQ Recommending Consideration for a National LDP.

Referral to Headquarters for recommendation for a National LDP shall be at the discretion of the Hub Director. When it is determined that the offense warrants such a measure, the Hub Director should forward all pertinent information along with a formal recommendation to the Deputy Assistant

Secretary for Multifamily Housing for review. The recommendation should include:

1. All related processing associated with the case(s) that initiated the action.
  2. A narrative summary detailing the description and nature of the alleged offense(s) committed.
  3. A synopsis of the participant's historic performance in past cases dealing with the Department.
  4. A recommend course of action to be taken.
- D. Questions should be addressed to the Director of the Compliance Division of the Enforcement Center.

### **15.17 Referral to the Mortgagee Board or the Inspector General**

- A. If the Hub/PC Director determines that a MAP Lender's actions or failure to act appears to be a compliance matter justifying action by the Mortgagee Review Board, including possible removal of its authority to do business as an FHA Lender, s/he must bring this matter and the administrative record to the attention of the Director, Office of Multifamily Production in Headquarters. The Director will refer the matter to the Director of the Mortgagee Review Board Division in the Office of Housing

*See Section 2-4, Requests for Mortgagee Review Board Action, HUD Handbook 4060.2 REV 2, Mortgagee Review Board, and HUD Regulations at 24 CFR 25.*

- B. If the issue involves possible fraud, material misrepresentation or other criminal violations, then the matter should be referred to the Office of Inspector General.

*See Section 3-1, Responsibilities of Departmental Management and Employees, OIG Handbook 2000.3 REV-4, Office of Inspector General Activities.*

### **15.18 Other Enforcement Actions**

Notwithstanding any provisions contained elsewhere in this Guide, HUD reserves the right to pursue remedies for false claims and false statements, as authorized by the False Claims Act, 31 U.S.C. §§ 3729-3731, the Program Fraud Civil Remedies Act, 31 U.S.C. §§ 3801-3812 and Civil Money Penalties under 12 U.S.C. § 1735f-14.

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# Chapter 16

## Master Lease Structuring to Facilitate the use of Historic or New Market Tax Credits

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### 16.1 Introduction

This chapter addresses the use of Master Leases when Historic and/or New Markets Tax Credits are used in conjunction with an FHA-insured loan. These transactions may or may not have Low Income Housing Tax Credits as well. HUD's goal is to accommodate this type of structuring without compromising appropriate regulatory oversight and controls.

This chapter does not address ground leases or leasehold interests in an entire project for purposes other than Historic or New Market Tax Credits, commercial leases or sublease agreements (of either commercial space or residential units).

### 16.2 Background

Master Leases maximize the benefits of combining Federal or State Historic Tax Credits and New Markets Tax Credits. The projects may or may not use Low Income Housing Tax Credits as well. Investors and developers participating in these programs benefit from increased leverage for project financing and premium pricing for equity, while reducing the need for additional debt.

Typically, these leases are structured to permit a combination of investments by one or more investors under one or more tax credit programs in a single development project. A sample organization chart for a master lease ownership structure is included in Appendix 16A. Generally the Master Lease structure involves the following parties, which often have total or partial identities of interest and common ownership:

- FHA Borrower – the Single Asset Mortgagor Entity (the lessor for the Master Lease);
- Master Tenant – the lessee; and
- Master Lease Sub-lessees for Residential units, and for Commercial space.

The Master Tenant must pay the Borrower/lessor rent that equals or exceeds the amount necessary to satisfy all financial obligations required under the insured mortgage and to operate the property in accordance with all HUD directives, regulations and contracts. The Master Tenant and all Master Sub-lessees (but not the individual residential and commercial tenants) will execute HUD Regulatory

Agreements and submit financial reports to HUD.

The HUD Multifamily Regional Center or Satellite Office will be responsible for approving Master Lease ownership structures in accordance with this chapter's requirements. The Regional Center Director retains waiver authority, but waivers of any provisions of this chapter should be discussed with and reviewed by Headquarters (HQ) Office of Multifamily Production prior to approval.

### **16.3 General - Programmatic Requirements**

In addition to other program requirements, the following are conditions for projects that use a Master Lease structure:

- A. The insured mortgage must be in first lien position with respect to all project collateral. The fee simple ownership in the land and improvements provides the security for the mortgage.
- B. All documents should include conflict language giving the HUD documents supremacy over other documents, except as otherwise permitted by HUD, and may not include indemnification provisions. In some cases HUD may allow non-monetary matters such as affordability use restrictions to be recorded ahead of HUD's mortgage but such variances are allowed only on a case by case basis.
- C. The Master Tenant and Master Sub-lessees must be single asset entities. Tenant-in-Common structures and Delaware Statutory Trusts are not eligible, though such entities may hold an "upper tier" interest in the single asset entities. The Master Tenant and Master Sub-lessees may not engage in any other businesses or activity, including the operation of any other rental project, or incur any liability or obligation except as permitted by HUD in connection with the project.
- D. The Master Tenant and Master Sub-lessees must execute the standard HUD Regulatory Agreement and Rider, to address various ownership and operational responsibilities with respect to the mortgaged property.
- E. The Master Tenant and Master Sub-lessees (as well as the Management Agent) must file management certifications and management entity profiles (HUD forms -9839 and -9832). HUD may require a management agreement to be terminated, in accordance with the terms and conditions contained in the management certification.
- F. Net rentable commercial area as a percentage of gross floor area and income will be determined in accordance with the applicable FHA program limitations.
- G. The Master Lease and all Sub-leases (sometimes collectively referred to as "Leases") shall be subordinate to the insured mortgage and subject to approval by HUD prior to execution. The Leases may not be modified or amended thereafter without the prior written consent of HUD, and may be terminated by HUD in the event that the insured mortgage is assigned. Any proposed modifications or amendments to the Leases must be approved by HUD's Regional Counsel. The Leases must incorporate by reference the Regulatory Agreement, HUD rules, regulations and directives, and contain an agreement to comply with their requirements. The Leases must include an obligation to

pay all rent due to the Lender, in the event of a default under the loan documents. The loan documents may be amended to provide notice of default to the Master Tenant contemporaneously with the giving of notice to the Borrower/Lessor, and the acceptance of a cure of such default, during such notice period, from the Master Tenant on behalf of the Borrower/Lessor. Any such cure must occur prior to the assignment to HUD, and will be limited to one opportunity to cure during each 12 month time period.

- H. Surplus cash determinations will be made in accordance with the Regulatory Agreements and will be made as if the entire project is owned and operated by one single purpose entity.
- I. All financial operations and reporting are governed by 24 CFR, Part 5, Subpart H.
- J. The rent paid by the Master Tenant must equal or exceed the monthly principal and interest payments due on the insured mortgage and all required escrows and reserves.
- K. All business agreements must be disclosed and are subject to HUD approval during loan underwriting (including, for example, inter- or intra-company loans, investor or outsider loans other than the insured mortgage, investor controls over operations, actions and deliverables that affect regulatory or contractual compliance or performance, etc.). The Firm Commitment will incorporate any conditions imposed by HUD with respect to such agreements.
- L. Any proposed payments (equity contributions, fees, income, etc.) to the Borrower, Master Tenant, Master Sub-lessees by a syndicator or investor must be disclosed to HUD and approved during loan underwriting, and thereafter be reflected on the annual financial statement filings and on any required monthly reporting. If such payments are made while any party is in non-compliance with the Regulatory Agreement, enforcement action will be taken against all principals in the organization, subject to the notice and cure provisions in above subsection E.
- M. Master Leases and Sub-leases must prohibit assignments or subleases (except to the end-users of the commercial spaces and apartment residents), unless previously approved by HUD in writing.

## **16.4 Processing Requirements**

### **A. Firm Commitment Special Conditions:**

1. The policies and procedures involving master lease structuring to facilitate the use of tax credits are incorporated herein and made a part of this Commitment for insurance of advances, specifically including, without limitation, the terms and conditions contained in Chapter 16 of the MAP Guide. All information submitted to HUD with the Application for Multifamily Housing Project, Form HUD-92013, to evidence the satisfaction of such terms and conditions shall be true and correct as of the date submitted, and must continue to be true and correct at the time of Initial Endorsement.
2. This commitment is subject to, and has been issued upon the reliance of, the successful (a) allocation to the project of LIHTC, Historic Tax Credits or New Markets Tax Credits and (b) syndication of such credits, with an appropriate agreement for the timely investment of equity, as shown on Forms HUD-2880 and HUD-92013, to assure completion of the project and pay other

associated and incidental costs. In addition to the standard provisions that must be included in the organizational documents for the borrower entity, a provision must be added that prohibits any changes to the organizational documents that affect the obligations of the tax credit investor without the written consent of the Lender and HUD.

3. Notwithstanding the issuance of this commitment, this commitment remains subject to, and HUD's obligations hereunder are conditioned upon the satisfactory resolution, as determined by HUD, of the adverse items determined by HUD during the Previous Participation Review process.
  4. As an accommodation, this commitment has been issued and based upon schematic drawings, instead of the final Drawings and Specifications. At least 30 days prior to the scheduled date for initial endorsement, HUD must receive the final Drawings and Specifications for review and approval to ensure consistency of design and cost. In the event that there is a net cumulative construction cost increase or change in the design concept, or a net cumulative construction cost decrease in the amount of more than 5%, this commitment shall be subject to and conditioned upon the further approval of the HUD, to be evidenced in writing, and may be terminated and voided by the HUD, or additional conditions may be imposed, at HUD's option.
  5. (See Section 5.28 for further policy guidance on the deferral of final plans and specifications at Firm Commitment when tax credits are involved.)
  6. Prior to and as an additional condition of Final Endorsement, because the project is exempt from providing a cost certification, when the project reaches 100% substantial completion, as deemed by the HUD Inspector, the Lender will be notified of the substantial completion date, and the Borrower must account for all operating income during construction and ending three months prior to the originally scheduled date of the first principal payment under the mortgage. An income and expense statement must be submitted covering the period from first occupancy (if occupancy occurred during construction) or from the date of substantial completion (as deemed by the HUD Inspector) through the period ending three months before the date of the first principal payment under the mortgage as originally scheduled. The statement must be submitted to HUD, at least 30 days before the date scheduled for Final Endorsement. If the income and expense statement evidences receipt of income net operating income during this period, the Borrower may be required to handle the funds in accordance with current cost certification guidance.
- B. The following forms should be revised to reflect the lease structure and HUD requirements:
1. Form HUD-92434M, Lender's Certificate (formally Borrower's Certificate) - To include language that clearly states that the Master Tenant and Sub-lessees must report lease payments during the construction period as rental income.
  2. Form HUD-93305M, Agreement and Certification - To include language that clarifies that the Borrower must report all receipts and disbursements from the date of first occupancy and during the rehabilitation period for substantial rehabilitation cases.
- C. Each Master Lease or Master Sub-Lease must be recorded in the appropriate real estate records, along with the Regulatory Agreement executed by each Master Tenant or Master Sub-Lessee. These documents must also be included in Schedule B, Part II of the title insurance policy. In jurisdictions where recording these leases would result in a substantial tax, a Memorandum of Lease may be used. In lieu of recording the lease(s), a lease memorandum approved by the HUD Multifamily Regional Center Director, after consultation with field counsel, may be filed.

## 16.5 Cost Certification and Final Endorsement

- A. The Borrower/Lessor, the Master Tenant and all Master Sub-lessees will be required to cost certify the actual costs of the project unless the property contains Low Income Housing Tax Credits and HUD determines at the time of Firm Commitment issuance that it has a loan to cost ratio of less than 80 percent. The cost certification must contain a certification signed by an authorized agent of each entity, audited by a CPA or IPA, and contain a Schedule of Tax Credit/Syndication Proceeds that includes the following:
1. The amount of syndication proceeds received from the investing partner to date;
  2. The purposes for which syndication proceeds received as of the cut-off date were used; and
  3. The dates, terms, and conditions under which future investor contributions are to be made.

- B. Total income of the Borrower/Lessor, including lease payments, is recognized during the construction/rehabilitation period.

If the replacement cost mortgage (Criterion 3) is not the controlling mortgage and there is excess NOI generated during construction, it may be applied to cover shortfalls in mortgageable soft costs, change orders, initial operating deficit and escrows. At Final Endorsement, funds not needed to cover shortfalls in costs or operating deficits may be distributed to the borrower or deposited into the project's Reserve for Replacement account or applied toward the amortization of the mortgage principal.

If Criterion 3 is the controlling mortgage amount, HUD will determine if the balance of the NOI is equal to or greater than 1% of the original mortgage amount and, if it is, will deduct this amount from the certified replacement cost. When the NOI does not meet this 1% threshold, it can be used toward shortfalls as noted above. Any remaining balance must be deposited into the project's Reserve for Replacement account at Final Endorsement and there is no distribution to the borrower. The Borrower/Lessor, Master Tenant and Master Sub-lessees are required to submit a certified operating statement which reflects the income collected and expenses incurred in accordance with the lease agreements and all documents required by HUD. Refer to Chapter 13 for further details on cost certification and the exemption from cost certification.

- C. A final Sources and Uses Statement must be included in the cost certification report as supplemental information and will be reviewed to determine actual sources and uses.

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# Chapter 17

## Refinancing Cooperative Housing Projects under Section 207 pursuant to Section 223(f)

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### 17.1 Introduction

The following provides processing instructions for refinancing Cooperative Housing Projects under the Section 207 pursuant to Section 223(f). This applies solely for refinancing a project and does not apply to projects that include an acquisition. Please note that proposed conversions or projects undergoing conversion, to cooperatives are not eligible for refinancing under this chapter.

### 17.2 Background

Cooperative ownership is popular in certain parts of the country, especially for low-to-moderate-income occupants. HUD already insures traditionally processed mortgage loans to facilitate the construction and substantial rehabilitation of Cooperative Housing projects under Section 213. Facilitating the refinancing of a Cooperative under Section 223(f) will further the Department's mission by assisting eligible Cooperative projects to obtain refinancing to make necessary repairs and/or consolidate more expensive outstanding debt, thereby serving to preserve the affordable housing stock. Refinancing the existing underlying mortgage is considered to be a better alternative than expending a Cooperative's reserve fund, which would have a negative impact on its financial stability and would help to avoid the need for a special assessment, which could harm low-to-moderate income occupants, especially those on a fixed income.

### 17.3 Program Requirements

The Underwriting Summary must demonstrate compliance with all program requirements.

- A. Loan Parameters. In accordance with Section 3.7.Q, HUD will insure a mortgage for a maximum term of 35 years or 75% of the remaining economic life of the property, whichever is less. The maximum insurable mortgage amount shall be the lesser of the following parameters as they relate to the criteria in Form HUD-92264-A, "Supplement to Project Analysis": (NOTE - An equity take out from a refinancing loan is not permitted for cooperative housing projects.)
1. Criterion 1. Mortgage or Loan Amount Requested in Application.
  2. Criterion 3. Amount Based on Value or Replacement Cost. The lesser of market value, valued as a market rate rental project multiplied by a loan ratio of 65%, or the Gross Sell-off Value, as a

market rate cooperative project multiplied by a loan ratio of 55% (value definitions are contained in Section II.B).

3. Criterion 4. Amount Based on Limitations per Family Unit. Use Section 207 statutory per unit limits, adjusted by the local PC High Cost Percentage for the locality. Follow the outstanding instructions for Criterion 4.
4. Criterion 5. Amount Based on Debt Service Ratio. A mortgage amount supported by 1.0 debt coverage based on the projected NOI as an existing Cooperative project based on its historic occupancy rate (up to 100%), which is NOI noted on line "5.e".\*

**\*NOTE:** In addition to the calculation of Criterion 5, the underwriter must perform a feasibility test comparing Criterion 5 as calculated above to a Criterion 5 calculation on a mortgage amount supported by a 1.538 debt service coverage based on projected NOI as a market rate rental project, which is NOI multiplied by 65%. The occupancy percentage for this scenario may not exceed 93%. This will be reported on page 4, "Remarks" of Form HUD-92264-A. If the amount based on NOI as an existing Cooperative project exceeds the amount based on NOI as a market rate rental project, the underwriter must comment on the feasibility of the project to continue as a Cooperative.

5. Criterion 7. Criterion 7 is not to be completed since acquisitions are ineligible.
  6. Criterion 10. Amount Based on Existing Indebtedness, Repairs and Loan Closing Charges. Follow outstanding instructions. The cost to refinance includes funding, if applicable, the Initial Funding of the Replacement Reserve and the Initial Deposit to the General Operating Reserve (see Section 17.3.F below). No equity out is permitted under Section 223(f) when refinancing Cooperatives, accordingly, the calculation for this criterion stops at line "10.g".
  7. Criterion 11. Amount Based on Deduction of Grants and Gifts and Loans. Line "11.a" shall be the cost to refinance plus FHA Mortgageable items taken from Line "10.g". Line "11.b" shall be total of grants, gifts and loan intended to offset the cost of mortgageable items. Line "11.c" shall be Line "11.a" minus Line 11.b".
- B. Eligible Borrowers. Eligible borrowers include non-profit Cooperative Ownership Housing corporations or non-profit Cooperative Ownership Housing trusts regulated under state law and regulatory agreements that require membership eligibility and transfer of membership in a manner approved by HUD. Limited profit ownership entities such as those established under the Mitchell-Lama program in New York City may be acceptable pending review by local Counsel.
- C. Application Processing. Applications for Cooperatives are processed in accordance with the current Section 223(f) instructions except as modified here.
- D. Required Exhibits. All exhibits normally required for a Section 223(f) application must be submitted with the following modifications and additions.
1. Rent Roll. The Rent Roll should be modified to indicate each shareholder's name, unit location, mailing address, whether or not the unit is owner occupied, whether or not the unit is subsidized, date of occupancy, ownership percentage, amount of monthly maintenance charge, any special assessments and past due balances of 30 days or more. For any units subject to local rent control, the actual rent must be substituted for the maintenance fee amount. The Rent Roll should be submitted as an Excel spreadsheet.

2. Cooperative Membership Exhibit. Subsequent to issuance of the commitment and prior to closing, the lender must submit a statement of the cost to the borrower and the Cooperative Membership Exhibit, Form HUD-93203. The number of members must equal the percentage (or number) of the total number of units as specified in the commitment.
  3. Original Project Prospectus (if available). The prospectus is prepared at the time of the original public filing and contains a great deal of useful information for technical discipline processing by HUD as well as the underwriter and preparers of third-party reports.
  4. Financial Statements for the Past Three Years. Follow the current instructions contained in Section 7.8.B and Section 8.4. The lender should review and evaluate any qualifications contained in the reviews to ensure the financial statements reliably represent the property's operating history and the assumptions relied on in the underwriting and should pay particular attention to the history of total past due balances of maintenance fees and special assessments. The total amount of the unpaid balance (30 days or more) for maintenance charges and special assessments as shown in the rent roll must not exceed 5% of the gross annual income.
  5. Environmental Exhibits.
    - a. Contamination Analyses. A Phase I ESA, if necessary a Phase II ESA, and, if further necessary, a remediation plan are required. See Chapter 9.
    - b. Environmental Report. As described in Chapter 9, an Environmental Report is required.
  6. Additional Third-Party Reports. HUD may require additional specialized reports to ascertain the safety and soundness of the property and its amenities as to their suitability as collateral for long-term financing.
  7. Organizational Documents and Minutes. The Hub/PC will provide the documents set forth in Handbook 4550.3, Existing Construction – Cooperative Housing. The following additional exhibits are required:
    - a. Certificate of Incorporation FHA Form No. 3234-B.
    - b. Resolution of Board of Directors to Mortgage Cooperative.
    - c. Shareholders authorization to Mortgage Cooperative.
    - d. Resolution of Board of Directors adopting FHA Form No. 3245, "Model Form of By-laws."
    - e. Shareholders authorizing adoption of FHA Form No. 3245, "Model Form of By-laws."
    - f. Minutes of the last six Board of Directors meetings.
    - g. Resolution of Board of Directors adopting FHA Form No. 3237, "Model Form of Occupancy Agreement."
    - h. Resolution of Board of Directors adopting FHA Form No. 3237-A, "Model Form of Sublease."
- E. Project Eligibility. The property must contain at least 5 residential units with complete kitchens and baths, and have been completed or substantially rehabilitated for at least 3 years prior to the date of application. Properties that were substantially rehabilitated with HUD-insured mortgages that have been completed with an expired latent defects guarantee are exempt from the Three Year-Rule. If the Cooperative was a conversion, the conversion must have been completed at least three years prior to the application date. Proposed conversions or projects undergoing conversions are not eligible. Projects with a recent or unresolved vacancy history, or a history of shareholders not paying dues, maintenance fees and other co-op obligations, will not be considered for mortgage insurance.

The project must be fully subscribed, with no units owned by the original developer, prior to endorsement and must meet these additional criteria:

1. **Project Design.** The project must be designed for primary residence only. Timeshares, resorts, Cooperative hotels or rental pools are not permitted. Section 513 of the National Housing Act prohibits the use of the insurance programs for transient or hotel purposes. The borrower and individual shareholders cannot execute Occupancy Agreements for less than 30 days nor provide occupants with hotel services such as maid service, furnishing and laundering of linens, room service and bellboys. Units may not be sub-leased without the consent of the Cooperative Corporation.
2. **General Market Conditions.** The Property must be located in an area evidencing strong market understanding and acceptance of Cooperative housing. Financing for the purchase of individual shares must be readily available from mortgage bankers/brokers, banks or saving and loan institutions. The Underwriting Summary must cite recent sales within the building and indicate the type of financing utilized.
3. **Repair Threshold.** A project cannot be processed under Section 223(f) if it meets the current requirements for substantial rehabilitation in Section 5.12. Projects that are not eligible for mortgage insurance under Section 207 pursuant to Section 223(f) should consider the Section 213 or Section 221(d)(3) programs.
4. **Fair Housing Act / Equal Opportunity Requirements.** All other applicable program requirements for the Section 207 pursuant to Section 223(f) program must be met, including compliance with applicable Civil Rights Laws, including the nondiscrimination and affirmatively furthering fair housing provisions of the Fair Housing Act, and applicable accessibility requirements for persons with disabilities.
  - a. **Affirmative Fair Housing Marketing.** The Affirmative Fair Housing Marketing Requirements (24 CFR Part 200, Subpart M) apply to all insured projects of five or more units but projects insured under Section 207 pursuant to Section 223(f) are exempt from the submission of a written plan. However, a Section 223(f) applicant is required to maintain records of its affirmative marketing efforts. Except in the case of a project specifically designed exclusively for the elderly (see below), the borrower must certify that it will not discriminate against families with children.
  - b. **Accessibility for Persons with Disabilities.** This is required for properties built after March 13, 1991, containing Fair Housing Act noncompliance. If a project built after March 13, 1991, is submitted for Section 223(f) refinancing and the PCNA inspection reveals that it contains noncompliance with the Fair Housing Act design and construction requirements, the Department must require that the owner correct the noncompliance as a condition of insurance. The extent of the noncompliance and the cost of correction will determine whether the project is feasible as a Section 223(f) or whether to resubmit it as a substantial rehabilitation. In no case may the Department insure projects with outstanding Fair Housing Act noncompliance.
5. **Elderly Developments - (aka Golden Age Cooperatives).** In refinancing of the underlying mortgage for an existing Cooperative project designed for the elderly, the Department defines the term "elderly person" in the National Housing Act (NHA) as a household composed of one or more persons at least one of whom is 62 years of age or more at the time of initial occupancy. Waiver of this definition is not permitted under any circumstances. It is noted that this definition differs from the definition in use for Section 213 of the NHA. The Cooperative shall not provide

mandatory meals and services such as those associated with retirement service centers. No non-shelter services can be a mandatory condition of occupancy and must be reviewed by the lender and approved by the Hub/PC for reasonableness. Non-shelter spaces already constructed for projects with current HUD-insured mortgages may include formal dining areas with meal services to be provided on an optional basis. All Cooperatives can provide modest kitchen equipment in a non-shelter space for the use of occupants or for catering services. The kitchen should be sufficient in size to support sanitary requirements. Additional requirements related to the provision of meals are as follows:

- a. Any meal service must be provided on an optional basis.
  - b. The cost of meals may not be included in the residents' rental charges.
  - c. The costs associated with the operation of the meals service are the responsibility of the entity that operates the optional meal service.
  - d. The borrower may receive payment from the operator of the meals service. In such cases, this revenue may not be included in the underwriting of the project, as this service is optional for each resident, thereby potentially producing a revenue stream that is both unpredictable and unreliable.
  - e. A determination should be made by the lender that the expenses associated with a third-party meal provider will not increase the project risk.
  - f. Any meal service must be operated by a meal provider licensed under State or local law and in compliance with current health and safety requirements for food service providers.
  - g. Local HUD Counsel must determine that the granting or revocation of any licensing required to operate a proposed meal service will not jeopardize the ability of the project to operate as Cooperative Housing in accordance with the requirements of the Regulatory Agreement.
  - h. Costs associated with developing a facility insured under Section 223(f) to include a meal service may be considered in the mortgage, subject to outstanding requirements limiting non-shelter space and commercial areas.
6. **Owner Occupancy.** At least 75% of the total number of residential units must be owned and occupied by Cooperative members at the time of endorsement, and no more than 25% of the units may be owned by investors.
  7. **Vacancy Rate.** The project should not have a vacancy rate greater than 5% since a higher vacancy rate may indicate a weak or problematic project or market. If an application is presented with a higher vacancy rate, the underwriter must provide convincing market evidence to support the transaction in the Underwriting Summary. The vacancy/occupancy rate used in underwriting the loan should be based on the actual historic performance of the project, which can be 100%. This applies only to Criterion 5 based on actual operation as a Cooperative project.
  8. **Turnover Rate.** The sales history of the complex should display a healthy turnover rate to demonstrate that the project is viable and that there is demand for the units. If the turnover rate is less than 5% of the total number of owner-occupied units per year, the underwriter must determine the reasons for the low turnover rate and why it does not pose an unacceptable risk, which must be documented in the Underwriting Summary. However, it should be noted that a project and/or market area may have a historically low turnover rate due to its popularity as a source of affordable housing.

9. Adequacy of the Proposed Carrying Charges. The carrying charge must be sufficient to adequately maintain the project at a level that would make it suitable as security for a long-term mortgage. The Underwriting Summary must contain an analysis of the Appraiser's findings regarding the adequacy of the proposed carrying charge that will be in place after refinancing has occurred and a discussion of the Cooperative project's policy and history regarding increasing the carrying charge. The Cooperative's Bylaws or other appropriate organizational documents must contain a provision that requires an annual increase in the carrying charge based on inflation, in order to address increases in operating expenses.
  10. Carrying Charge Increase. In general, the debt service resulting from the proposed mortgage should not require a carrying charge increase of more than 5%, which may be exceeded, so long as all of the following requirements are met:
    - a. The carrying charge is below market for properly maintained similar projects, and is not sufficient to adequately maintain the project.
    - b. The Board of Directors must approve the carrying charge increase in accordance with its By-laws the FHA Model Form of By-laws, FHA Form No. 3245.
    - c. An analysis of the demographic data in the appraisal report must indicate the new maintenance fee would be affordable for the typical resident.
    - d. Market analysis of the proposed maintenance carrying charge indicates that it is within market limits for similar projects in the subject's market area.
  11. Commercial Space Limitations. The current Section 223(f) parameters must be followed.
  12. Ownership of Commercial Space/Parking. Commercial and parking space at a Cooperative Housing project may or may not be owned by the Cooperative. Only those spaces that are owned by the Cooperative may be included as part of the collateral.
  13. Ground Leases. Ground Leases must conform to the FHA Lease Addendum Form HUD-92070M. The term of the lease addendum may be varied to conform with applicable State and local law, except that the local HUD Closing Attorney must approve:
    - a. The legal need for any proposed lease term changes, and
    - b. That any term changes are consistent with the following requirements:
      - (1) Term is 99 years and is renewable, or
      - (2) Term is at least 50 years from the date the mortgage is executed (where a lease is on trust/other land on a reservation the HUD Closing Attorney must ensure that the lease provisions are coordinated with Bureau of Indian Affairs' requirements).
- F. General Operating Reserve (GOR). Cooperatives are required by the Regulatory Agreement, FHA Form No. 3225 to establish and maintain a GOR which is a percentage of the monthly carrying charges. The carrying charge is the sum of all project expenses, replacement reserve, taxes and debt service.
1. GOR formula.
    - a. The GOR is maintained by a monthly payment of 3% of the monthly carrying charges.
    - b. When the GOR account reaches 15% of the annual carrying charges, the monthly rate may be reduced to 2%.

- c. When the GOR account reaches 25% of annual carrying charges, monthly accruals may be discontinued until the account is reduced below 25%.
  - d. Anytime the GOR falls below the 25% level, monthly payments to the account shall be resumed at a 2% to 3% rate, as noted above, until the 25% level is restored.
2. In addition to any Initial Deposit to replacement reserve, the Cooperative borrower may be required to make an Initial Deposit to the GOR not to exceed 15% of the annual carrying fee. The Initial Funding of the GOR using this provision may be included in the cost of refinancing up to an amount equal to 15% of the annual carrying fee.
- G. Model Forms and Closing Documents. Use Handbook 4550.3, Existing Construction – Cooperative Housing, Appendix III (modified for Section 223(f)). Cooperative Organizational forms and documents must be reviewed and approved for legal and programmatic compliance before the issuance of a Firm Commitment. Use FHA Required Closing Instruments, FHA Form No. 3257-B, also set forth in Handbook 4550.3, Appendix 3-10. (See Section 17.3.D.7 above). The Hub/PC will provide the documents set forth in Handbook 4550.3.

## **17.4 Program Requirements – Technical Processing**

- A. Architectural and Cost Processing for Cooperatives. Follow the current instructions for Section 223(f). A summary of these procedures is outlined below.
- 1. Architectural Analysis. Lender will submit and HUD will review deliverables as specified under the present guidance for Section 223(f) to the Hub/PC.
  - 2. Cost Processing. The HUD Cost Analyst will review lender exhibits as required in Chapter 5 and will recommend either acceptance or rejection of the Cost portion of the Firm submission.
  - 3. PCNA. The primary purpose of the PCNA for a Cooperative project is to assess the Capital Needs of the project with the exception of any elements owned by the individual shareholders. So, it is very important to ascertain exactly what items are the sole responsibilities of the Cooperative. In some cases, appliances, kitchen cabinets, etc. may actually be owned by the Cooperative. The interior of individual units are still inspected in the same manner as with apartments. Any hazards or defects that would affect safety and marketability of the Cooperative should be noted even if it is an individual shareholder's responsibility. These items must be corrected at the shareholder's expense prior to endorsement. Mortgage proceeds must only be used for repairs of property owned by the Cooperative.
- B. Valuation Processing - Appraisal Scope-of-Work for Cooperatives. There can be great variation in how a Cooperative is structured. According to the USPAP, the determination of Scope-of-Work is an ongoing process in an assignment. Information or conditions discovered during the course of an assignment may cause the appraiser to reconsider the scope-of-work. Therefore, the guidance set forth below may be modified on a case-by-case basis to assure compliance with USPAP and that the results of the appraisal assignment will be reliable for making underwriting decisions. There are four major elements for the appraisal assignment: General Requirements, Valuation as a Market Rate Rental Project, Market Analysis for Continued Use as a Cooperative, and Hypothetical Gross Sell-Out Value as a Cooperative.
- 1. General Requirements.

a. Selection of the Appraiser. The lender must select a qualified Appraiser in accordance with Chapter 7. It should be noted that the appraisal of a Cooperative is very specialized. Lenders should base their selection of an Appraiser on their experience for this type of assignment and upon their familiarity with the subject's market area.

b. Value Definition. Appraisers must use the following definition published by Federal Regulatory agencies:

“Market value means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- (1) buyer and seller are typically motivated;
- (2) both parties are well informed or well advised and acting in what they consider their own best interests;
- (3) a reasonable time is allowed for exposure in the open market;
- (4) payment is made in cash or by financial arrangements comparable thereto; and
- (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.”

The value shall be estimated assuming that all repairs have been completed as of the date of the appraisal.

c. Inspection of the Subject and Comparables. The primary appraiser designated by the lender and accepted by HUD must physically inspect the subject (both exterior and interior) and all of the comparables used as part of the analysis and must sign the Certification within the appraisal report and the supporting HUD forms.

(1) The primary appraiser must inspect at least one of each bedroom/unit type. The total number of units inspected must equal or exceed 5% of the total number of units for projects of up to 200 units, or 4% of the total number of units/beds for projects greater than 200 units. If the characteristics and/or condition of the subject indicate that a higher level of inspection is necessary, it is the appraiser's responsibility to expand the scope of the work as is necessitated by the observations made by the primary appraiser during the inspection of the subject. This is especially important where the improvements are high-rise structures whereby individual units within demonstrate varying degrees of light and view qualities. If there are hazardous conditions or other factors that preclude a thorough inspection of the interior, the appraiser must clearly indicate these circumstances in the appraisal report.

(2) Large Projects. For projects exceeding 500 units, the appraiser must consult with the processing office to agree on a reasonable number of units to be inspected. In addition, the appraiser may employ assistants to inspect individual units. The purpose of allowing assistants is to encourage a thorough inspection. The names and qualifications of these assistants must be disclosed in the appraisal report but they are not required to sign the report.

(3) The primary appraiser must inspect all of the comparables used in deriving an estimate of value, including land comparables (if applicable), improved comparables sales, expense

comparables and rental comparables. The appraiser must verify the condition of the comparables at the time of transfer/rental with management or other personnel familiar with the property. Contact information must be documented in the appraisal report.

- d. Required Appraisal Report Exhibits. In accordance with the requirements of Chapter 7 and the programmatic requirements of Section 223(f).
  - e. Review of the PCNA and Phase I ESA. The appraiser must review the PCNA and ESA prior to completing the assignment, comment on any remarkable findings and their impact (if any) on value.
  - f. Required Approaches. In accordance with the requirements of Chapter 7 and the programmatic requirements of Section 223(f).
  - g. Estimation of Remaining Economic Life (REL). In accordance with the requirements of Chapter 7 and the programmatic requirements of Section 223(f).
  - h. HUD Forms. All of the usual forms for Section 223(f) should be employed, (92264, 92264-A, 92273 and 92274) following the outstanding instructions for Section 223(f). The Form HUD-92264 shall be completed based on usage as rental apartments. The Gross Sell-Out Value should be summarized in Section "O"; (Remarks).
  - i. Additional Appraisal Work Required by the lender or other Intended Users. The appraiser is bound by USPAP to complete the appraisal assignment in compliance with the requirements of the person or entity who ordered the report and to satisfy the needs of identified intended users.
  - j. Reconciliation and Conclusion. The appraiser must briefly reconcile the information presented; clearly indicating what data is the most relevant and supports the report's conclusions. The conclusions must indicate whether or not the subject can expect to enjoy long-term use as a Cooperative; and whether or not the proposed maintenance fee is within market limits and is affordable for the typical shareholder.
  - k. Report Content and Format. In accordance with the requirements of Chapter 7.
2. Valuation as a Market Rate Rental Project. Follow all current procedures in Chapter 7 for Section 223(f) Appraisal and Appraisal Review, including these additional instructions:
    - a. Use of the Subject. The appraiser shall assume a hypothetical use of the subject as a market rate rental project, except that income from any units subject to rent control will assume the current controlled rental amount.
    - b. Estimate of Effective Gross Income. The estimate of Effective Gross Income shall be made using market rental housing comparables that are equivalent to the subject in location, size and style. Actual rents should be used for any rented units in the Cooperative that are subject to rent control. Market rents must be used for any subsidized units. Vacancy and collection losses should also be market derived, but in no event will a residential occupancy rate greater than 93% and a commercial occupancy rate greater than 80% be used.
    - c. Expense Analysis. The Expense analysis should accurately reflect usage as a market rate rental project. Appropriate weight should be given to the most recent three year history for items such as repairs, maintenance and common utilities. Other items such as taxes and management expense should be based on rental apartment market data.
  3. Market Analysis for Continued Use as a Cooperative. The appraisal report must also contain a Level C Market Analysis of the local market with an emphasis on Cooperatives. The purpose of

the analysis is to determine the ability of the subject to continue usage as a Cooperative Housing project. The detailed requirements for performing a Level C analysis can be found in “Market Analysis for Real Estate”, published by the Appraisal Institute. The study must also address these additional requirements.

- a. Assumptions. The study should assume that management has budgeting and operations under control; which can be demonstrated by an illustration of past years maintenance charge history.
  - b. Financial Statement Review. Special Assessments should be explained, and a review of the last three years financial statements is required. (See Section 17.3.D.4 above for specifications for financial statements). The footnotes to the Cooperative’s yearly financial statement are a typical source of details regarding past, current and upcoming issues. There should be a discussion of any material or atypical items as to their impact on value. In addition, the appraiser will complete a Form HUD-92274 using comparable Cooperative projects and also analyze the past three years records and any unaudited records from the most current period, if deemed reliable, to ascertain if the proposed maintenance charge is adequate to continue operations.
  - c. Cost of Occupancy/Cost of Ownership Analysis. The typical monthly maintenance charge by unit type should be compared to the competing project’s monthly maintenance charges by unit type and will serve as a variable for Cost-of-Occupancy/Cost-of-Ownership calculations to ascertain and support market-oriented unit pricing. The appraiser will complete a Form HUD-92273 for each major Cooperative unit type using other units from other Cooperative projects as comparables to compare monthly maintenance fees and to determine if the proposed monthly fee is realistic and affordable for the subject’s market area.
4. Hypothetical Gross Sell-Out Value as a Cooperative. The appraiser will develop a value estimate based on a Gross Sell-Out of all units, using comparable sales analysis and any other industry acceptable methods, before the application of all costs and entrepreneurial profit associated with a conversion from a rental property to a cooperatively owned property and further assuming a vacant and moderately renovated unit. Additionally, this value is over and above a pro rata share of an underlying mortgage encumbering the premises. Based on the proposed mortgage refinancing, it is considered that such debt conforms to the influencing market parameters. A sample breakdown of the Gross Sell-Out Value is as follows:

Gross Sell-Out Value:	
Gross Sell-Out for Residential Units (453 Rooms x \$48,000/Rm)	\$21,744,000
Unpaid Balance of Underlying Mortgage	\$2,858,300
Total Gross Sell-Out Value and Underlying Mortgage	\$24,602,300
Rounded	\$24,600,000

5. Appraisal Review. HUD Multifamily Staff Appraisers will review the appraisal in accordance with USPAP Standard 3. The appraisal review must include a comparison of the subject’s proposed monthly maintenance fees based on the new financing to what the various units would rent for if the subject were operated as a rental project. A Cooperative Housing project’s feasibility for continued use as a Cooperative is questionable if monthly maintenance fees

significantly exceed what units could actually rent for. A downward trend in rents versus no change or an upward trend in maintenance fees is an indication of an unhealthy Cooperative Housing project/market.

- C. Environmental Processing. The HUD Review Appraiser will follow all applicable instructions in Chapter 9.
- D. Mortgage Credit Processing. Follow the current procedures in Chapter 8 for Section 223(f) modified as follows:
1. Determination of the Acceptability of the Cooperative Corporation.
    - a. BOD Performance History. In processing an application, the lender will take into account the BOD's ability and willingness to manage the Cooperative within the requirements of Section 223(f). The lender will also consider all applicable requirements contained in Chapter 10, Management Analysis.
    - b. Ability to Close. It must be determined that the Cooperative organization has the ability to close the transaction in a satisfactory manner and that the sum of the monthly charges to members will be adequate to meet debt service and other ownership expense. It must also be determined that the present members of the Cooperative, as a group, have the ability to provide whatever additional funds may be required to close the transaction.
    - c. Credit-Worthiness. It must also be determined that participants have not been debarred or subject to a Limited Denial of Participation, and are otherwise capable of meeting their ownership and management obligations. For the Single Asset Borrower Entity, its Officers and BOD Members, and the Management Agent, the review should include the following documents:
      - HUD-92013 SUPPLEMENT
      - HUD-2530 / APPS Clearance (or successor form)
      - Verification of Deposits
    - d. Other Business Concerns. List of other business concerns, are required for the Officers of the BOD.
    - e. Adequacy of Monthly/Annual Charges. The underwriter must ensure that the sum of monthly charges, as listed on Cooperative Membership Exhibit, converted to an annual basis, is sufficient to meet the HUD estimate of debt service, Cooperative operating expenses, taxes, special assessments and ground rents, if any, plus a general operating reserve of 3% of these items. In making these determinations of allowances for accessory income (if any), the allowance shall not exceed the Cooperative's estimate or the appraiser's estimate of accessory income, whichever is the lesser. However, rental payables under duly executed acceptable leases for commercial space on the premises shall be used in lieu of estimates. These payables should be totaled to be sure all members have assurance that the total membership has their required minimum equity requirements. The HUD estimate of annual charges will include the following:
      - Debt service payments.
      - Cooperative Operating Expenses, Reserve for Replacements, Taxes, Special Assessments and Ground Rent, if any.
      - (Memorandum attached to Form HUD-92264). General Operating Reserve of 3% of

Sum of Above.

- f. Review of the Cooperative's Procedure for Approving New Members. The procedures employed by the Cooperative in approving new members (cooperators) should be reviewed to ascertain if there is compliance with any income requirements and credit scores as contained in the Cooperative's bylaws or other related agreements. Individual files for anyone becoming a member in the three month period immediately prior to the date the application for Firm Commitment was submitted must also be reviewed by the HUD processing office.
  - g. Maintenance Charges. The Hub/PC must review the procedures employed by the Cooperative in reviewing its budget, determining the adequacy of the carrying charge and to its history of carrying charge increases. The Cooperative's Bylaws or other appropriate organizational documents must contain a provision that requires an annual increase in the carrying charge based on inflation, in order to address increases in operating expenses. The total amount of the unpaid balance (30 days or more) for carrying charges and special assessments as shown in the rent roll must not exceed 5% of the gross annual income.
2. Determination of Total Debt Service, Cooperative Operating Expense and GOR. Total Debt Service will be calculated by multiplying the amount of the mortgage by the sum of initial curtail rate, interest rate and MIP. Cooperative Operating Expense includes those operating expenses, reserve for replacements, taxes, special assessments and ground rents, if any, which are the responsibility of the Cooperative membership as a whole rather than of the individual members and will include the cost of occupancy of the units assigned to employee use. The GOR is 3% of the sum of the annual charges described above, and is accumulated as a special reserve in order to meet possible contingencies.
  3. Outstanding Debt. Past due accounts payable and outstanding project liabilities must be cleared and released, or otherwise fully satisfied, prior to or at loan closing. Examples of such items include deferred management fees, overdue utility bills or real estate taxes, or trade payables. These items are not to be included in the eligible debt basis.
  4. Completion of the Form HUD-92264-A and Determining the Maximum Insurable Mortgage. Pages 1-2 of the form HUD-92264-A shall be completed according to existing instructions, modified as noted in Section 17.3.A.
- E. Asset Management Processing. The application must include the applicants' management plan, including training requirements, and a description of maintenance procedures and management of the Reserve for Replacement funding and work items.

## **17.5 Program Requirements – Issuance of Firm Commitment and Loan Closing**

Follow Section 223(f) closing procedures in the Multifamily Closing Guide and contact the Hub/PC for the FHA Required Closing Instruments, FHA Form No. 3257-B, set forth in Handbook 4550.3, Appendix 3-10.

**NOTE: The MAP Forms contained in this Appendix that are used by lenders and by HUD processing staff will be updated, revised and reissued in a Housing Notice after the Department has completed work that is currently underway to streamline application processing and program requirements. The Forms are otherwise unchanged.**

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## **Chapter 18**

### **Section 223(a)(7)**

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#### **18.1 Purpose of Section 223(a)(7)**

Section 223(a)(7) of the National Housing Act (NHA) permits refinancing of HUD-insured multifamily projects. Refinancing results in prepayment of the existing mortgage, endorsement of a new mortgage and assignment of a new project number. Refinancing through Section 223(a)(7) typically reduces project debt service and increases cash flow by lowering the interest rate of the mortgage and/or by extending the amortization period. The increased project cash flow benefits properties and owners and reduces risk to the FHA Insurance Fund.

Section 223(a)(7) is applicable only to certain mortgages currently insured by FHA, as described below, and to HUD-held loans on projects subject to the Multifamily Assisted Housing Reform and Affordability Act of 1997 (MAHRA). A mortgage refinanced pursuant to Section 223(a)(7) is insured under the same section of the NHA as was the mortgage originally insured under that section of the act, for example, Section 221(d)(4) or Section 223(f).

Section 223(a)(7) refinancing is limited to existing properties in residential use, and cannot include new construction or expansion of the height or footprint of an existing building, or any repairs which involve ground disturbance. Proceeds may be used to fund (a) the payoff of existing FHA-recognized indebtedness (b) the cost of refinancing, (c) the cost of critical and non-critical repairs (as described in the required Capital Needs Assessment, subject to the cost limits as described in Chapter 5.1.C.1 and 5.10.B), and (d) deposits to reserve for replacement accounts. By statute, equity take-outs are not permitted under Section 223(a)(7).

#### **18.2 Consolidation of applicable guidance**

This Chapter provides guidance on processing Section 223(a)(7) refinancing transactions for all currently insured multifamily properties. Programs administered by the Office of Healthcare Programs are not covered by this Chapter.

This Chapter consolidates portions of previously issued guidance and incorporates new guidance and practices. This Chapter updates and clarifies past guidance replacing applicable portions of the following documents:

- Handbook 4567.1, Refinancing of Insured Multifamily Projects Pursuant to Section 223(a)(7),
- Housing Notice 93-89, Expedited Section 223(a)(7) Processing Instructions,
- Mortgagee Letter 94-17, Refinancing of Insured Mortgages Pursuant to Section 223(a)(7) of the National Housing Act – Questions and Answers, and
- Mortgagee Letter 2006-03, Refinancing of FHA Insured Multifamily Project Mortgages Pursuant to Section 223(a)(7)

### **18.3 Basic Program Requirements**

Standard Processing Time. In general Section 223(a)(7) transactions should be processed expeditiously to reach a Firm Commitment decision within 30 calendar days of receipt of a complete application.

- A. Eligibility. These instructions apply to the refinancing of multifamily properties with full insurance mortgages and previously coinsured mortgages converted to full insurance. Mortgages excluded from these instructions are:
1. risk share mortgages,
  2. co-insured mortgages, and
  3. Section 202 loans and other HUD-held mortgages (other than those subject to a debt restructuring under the Multifamily Assisted Housing Reform and Affordability Act (MAHRA)).
- B. Maximum mortgage (Form HUD-92264-A apply Criteria 1, 2, 5, & 10). The mortgage may not exceed the lowest of the following:
1. Criterion 1 - Amount that is lower than the lowest of the amounts derived in paragraphs 2., 3., and 4., of this Section B below.
  2. Criterion 2 modify to read the “Original principal amount of the existing insured mortgage” that is to be refinanced (or the sum of the original principal amount of all mortgages to be refinanced if two or more mortgages on one single property are being refinanced).
  3. Criterion 10 - Amount based on the cost to refinance the existing insured mortgage and other permitted debt, permitted repairs, capital improvements, and loan closing charges. The unpaid principal balance of the existing insured mortgage (or mortgages if more than a single mortgage are being refinanced), plus a., b. and c. below:
    - a. Loan closing charges, including the application fee, upfront Mortgage Insurance Premium (MIP), financing fee, total costs of prepayment penalties associated with the mortgage note, title and recording fees, and legal fees associated with the refinancing, and required deposits to the reserve for replacements.
      - (1) The allowable application fee is the amount anticipated to be paid net of any post-closing refund.
      - (2) The cost of defeasance of any existing bond issue and bond discounts exceeding 10% of the proposed mortgage amount may not be included.
      - (3) Discounts. The cost of any discounts may not be included in estimating the maximum

mortgage amount.

- b. Outstanding debt incurred in connection with capital improvements made to the property that are acceptable to the Regional or Satellite Office.

Indebtedness incurred in connection with funding operating deficits, deferred management fees or other non-capital costs (other than Section 223(d) loans) are not eligible for inclusion in calculating the maximum mortgage amount available for refinancing under Section 223(a)(7) nor are past-due payables. See Section 8.5.B.7 for a discussion of clearing or resolving past-due payables at the time of closing.

- c. HUD-approved Critical and Non-critical repairs costs.

For a discussion of permitted repairs, please see Chapter 5.1.C.1., Eligible Construction Activities by Program, and Chapter 5.10.B., Processing for Refinance or Acquisition, Section 223(f) and 223(a)(7) and 241(a) for Repairs and Alterations.

- (1) Generally, Critical repairs must be completed prior to endorsement. See Chapter 5.1.J., Maximum Time for Completion of Repairs.
- (2) Non-critical repairs may be deferred but should be completed within twelve months of endorsement. Generally a 10% escrow will be established, which may be funded with a letter of credit. For further discussion, see Chapter 5.1.L., Funding Repairs, Escrow Agreement for Deferred Repairs. HUD may determine that a larger escrow is appropriate for projects with more extensive repairs, or may waive the escrow for very minor replacement cost items.

- 4. Criterion 5 - Amount based on debt service ratio. The amount that can be amortized by the applicable percentage described below of the project's estimated net operating income. The mortgage may exceed this amount by capitalizing the savings from any tax abatement that runs with the land. Physical occupancy assumptions used in calculating the project's estimated net operating income should be based on historical occupancy levels.

<u>Rent Structure</u>	<u>Minimum Debt Service Coverage Ratio (DSCR)</u>	<u>Form 92264-A Criterion 5 loan ratio</u>
Projects with >90% of units assisted by Project-Based Section 8, and Cooperative Housing insured under Section 213	1.05	95.0%
All other projects	1.11	90.0%

- C. Mortgage term. The term of a new mortgage insured pursuant to Section 223(a)(7) may be extended up to 12 years beyond the maturity date of the existing, originally insured mortgage. The term cannot be extended beyond 75% of the remaining useful life of the project or the maximum term permitted in the section of the act under which the existing mortgage is insured. If the existing mortgage is the result of a previous refinancing through Section 223(a)(7), the longest allowable maturity date of the new mortgage is 12 years beyond the maturity date of the mortgage originally insured under the FHA

insurance program but not to exceed 75% of remaining useful life.

**Example of allowable term/maturity date extensions  
for a Section 223(a)(7) refinancing  
of a mortgage currently insured under Section 223(f)**

Assumptions			
Current loan program		Section 223(f)	
Maximum permitted term under the applicable program		35 years	
Assumed amortization start date		January 1, 2000	
Examples of permitted term/maturity extensions for loans of different initial terms			
	Maturity date (original term)	New maximum maturity date if refinanced under 223(a)(7) on January 1, 2010	New maximum maturity date if refinanced for a second time under 223(a)(7) on January 1, 2013
Example 1	January 1, 2035 (35 years)	January 1, 2045 (any later maturity would violate the maximum 35-year term limit under the applicable SOA, in this case 223(f))	January 1, 2047 (any later maturity would violate the maximum 12-year extension of the original mortgage's term)
Example 2	January 1, 2030 (30 years)	January 1, 2040 (any later maturity would exceed the 30-year term of the original mortgage)	January 1, 2042 (any later maturity would violate the maximum 12-year extension of the original mortgage's term)

**Example of allowable term/maturity date extensions  
for a Section 223(a)(7) refinancing  
of a mortgage previously insured under Section 221(d)(4)**

Assumptions:			
Original loan program		Section 221(d)(4)	
Maximum permitted term under the 221(d)(4) program		40 years	
Assumed amortization start date of the Original 221(d)(4) loan		January 1, 2000	
Current loan program (see Example 3 and Example 4 below)		Section 221(d)(4) or Section 223(f)	
Examples of permitted term/maturity extensions for loans with different refinancing histories			
	Maturity date (original term) as a Section 221(d)(4) project	New maximum maturity date if refinanced under 223(f) on January 1, 2010	New maximum maturity date if refinanced under 223(a)(7) on January 1, 2013
Example 3 A (d)(4) loan is refi'd with a 223(f), and that is refi'd with an (a)(7)	January 1, 2040 (40 years)	January 1, 2045 (the maximum 35-year term limit under the applicable SOA, in this case 223(f))	January 1, 2048 (any later maturity would violate the maximum 35-year term limit under the applicable SOA, in this case 223(f))
Example 4 The same (d)(4) loan above is not refi'd with a 223(f) loan, but is refi'd with an (a)(7)	January 1, 2040 (40 years)	Not Applicable for this example (No 223(f) refinancing on this date)	January 1, 2052 (any later maturity would violate the maximum 12-year extension of the original mortgage's term)

If two or more existing FHA-insured multifamily loans (for a single property) are to be refinanced into a single Section 223(a)(7) loan, the term of the new Section 223(a)(7) mortgage may not exceed 12 years beyond the maturity date of the earliest-to-mature originally insured mortgage.

Any extension of the new mortgage term beyond the remaining term of the existing mortgage may not result in a mortgage term that exceeds 75% of the remaining useful life of the property.

- D. Mortgage Insurance Premium. At endorsement, the borrower must pay an upfront MIP of ½ percent (0.50%) of the mortgage amount or as subsequently revised in a Federal Register note. The mortgagee

of record must submit Form HUD-9807, Request for Termination of Multifamily Mortgage Insurance, to obtain a refund for the borrower of a portion of the MIP paid pursuant to the original mortgage.

E. Environmental review requirements.

1. A Phase I Environmental Site Assessment is not required. Pursuant to 24 CFR 50.19(a)(21), there are no environmental review requirements and the form HUD 4128 “Environmental Assessment and Compliance Findings for the Related Laws” does not have to be filled out. Transactions that require repairs in excess of routine maintenance are not appropriate for processing under Section 223(a)(7). (See Chapter 9.1 Subsection A, paragraph 5.)
2. Flood insurance. The lender must determine if the property is located in a special flood hazard area (based upon the most recent Flood Hazard Map) per Section 9.5.E.1. If the site is determined to be in such an area, the borrower must obtain and maintain Flood Insurance coverage for the duration of the mortgage.

F. Fees.

1. Application fee - The non-refundable application fee paid to HUD is 15 basis points.
2. Maximum fees – Lenders may charge financing fees that may not exceed the amounts below. Fees may be increased for bond transactions to cover fees associated with costs of issuance. Legal fees paid by the lender are not included in Lender Fees for purposes of the calculations below.

New Loan Amount	Maximum Lender Fees (not bond transactions)	Maximum Lender Fees (bond transactions)
Portion of loan amount above \$2,000,000	2.00%	4.00%
Loan amount up to \$2,000,000	3.50%	5.50%

3. Inspection fee - There is no inspection fee even if there are deferred non-critical repairs.

G. Project Numbering. Projects will be assigned the next FHA number under the same Section of the Act under which the project was originally insured.

H. Regulatory Agreement. A new Regulatory Agreement must be executed at closing under the same Section of the Act as the original loan (including modifying the principal(s) in provision 50). Amending and restating the existing Regulatory Agreement is not permitted.

I. Cost Certification. Cost certification is not required. As a condition of the Firm Commitment, HUD may require the borrower to produce information related to the cost and completion of Critical and Non-critical repairs and to provide appropriate documentation to HUD, including, at a minimum, invoices, receipts and photos, as repair funds are drawn from escrows. The need for site visits in

connection with the completion of repairs or escrow draws will be determined by the Hub Regional or Satellite Director of the HUD office with jurisdiction over the property. Projects with minor repairs typically would require few, if any, site visits by HUD staff.

- J. Commencement of Amortization. Amortization will begin on the first day of the second month following the date of the initial/final endorsement of the mortgage note.
- K. Source of Funds for Prepayment Penalty Costs.
- a. Prepayment penalty costs are, as discussed in 18.3.B.2.a., eligible mortgageable costs. The amount of the cost that is not supported by the mortgage must be paid from other sources.
  - b. The one exception to the general prohibition that lenders may not pay or otherwise provide funds for borrower costs is that in 223(a)(7) transactions lenders may pay prepayment penalty costs.
  - c. The lender's application must include an estimated Sources and Uses statement specifying the amount of any lender fees or profit used to pay prepayment penalty costs and if the total prepayment penalty costs associated with the mortgage note(s) to be repaid exceed such amount, the amount of prepayment penalty costs to be paid from other sources, specifying such source(s).
  - d. The amounts of lender fees or profit and borrower or other funds used to pay prepayment penalties should be shown as sources in the project's Sources and Uses statement
  - e. The lender cannot pay, either directly or indirectly, for repairs or costs other than Prepayment penalty as noted above. The source of funds for repairs and transactions costs must be accounted for separately in the project's Sources and Uses statement.
- L. Refinancing Partial Payment of Claim (PPC) Properties. A recast first mortgage loan and an associated Partial Payment of Claim second mortgage may both be refinanced in a Section 223(a)(7) transaction so long as the new loan amount does not exceed the original principal amount (i.e., the original pre-Mark to Market or PPC restructuring loan amount) and it is clear the market or project conditions have improved to the point there is little risk the new loan will default.
1. HUD will require that the HUD-held second mortgage be (1) paid off in full or partially paid off; and (2) subordinated and remain secured. If partially paid off or remains unpaid, HUD will maintain the surplus cash split of 25% to owner and 75% to pay down the HUD-held second (statutory under MAHRA). Pursuant to the owner paying down (or paying off) the HUD second mortgage with available loan proceeds, mortgage proceeds must first be allocated to fund the reserve for replacement account (in the amount required by the CNA) and make needed repairs to assure the ongoing value and viability of the asset. HUD will consider modifying the required 25-75% split, on a case by case basis (subject to MAHRA constraints) where debt service savings will allow.
  2. Upon refinance, debt service payments will not exceed what is currently in place. Since these properties have previously undergone a PPC, HUD would not want them encumbered with additional debt which could negatively affect future financial stability. Consequently, the interest rate on the new mortgage must be competitive enough such that substantive savings in debt service payments will result.

3. The debt service coverage rate of 1.2 will be required to account for the additional risk inherent with a former PPC.

Processing of such a transaction would follow the same procedure as that of other multiple mortgages permitted to be wrapped into a single 223(a)(7) refinance transaction. HUD regional or satellite office production staff should solicit particular input from asset management staff on these transactions.

**M. Commitment, Regulatory Agreement and Closing.**

1. Commitment. The commitment should be in letter form listing the: a) commitment amount, b) the Section of the Act with any appropriate further reference, e.g., 223(a)(7) pursuant to 221(d)(4), c) loan terms and requirements, d) any required repairs, e) the requirement for executing a new Regulatory Agreement, f) the requirement that the owner notify OAMPO when any repairs deferred until after endorsement are underway and/or completed, and g) any Special Conditions.
2. The commitment is valid for a period of 90 days. It is not anticipated that extensions will be necessary in a Section 223(a)(7) refinancing. However, the Hub or PC Director may extend Section 223(a)(7) commitments for a maximum of three additional 30-day periods, provided that processing and underwriting conclusions are updated as necessary so they are current at the time of any extension.
3. The commitment must require that the existing Reserve for Replacements be transferred in total to the new mortgage, and specify the dollar amount of funds to be transferred and the amount of additional replacement deposits.
  4. Closing. Loans shall be closed in accordance with the Closing Guide, available at [http://portal.hud.gov/hudportal/documents/huddoc?id=14\\_MF\\_CLSNG\\_GD.PDF](http://portal.hud.gov/hudportal/documents/huddoc?id=14_MF_CLSNG_GD.PDF).

## **18.4 Processing**

- A. Eligible Section 223(a)(7) applications submitted by lenders approved to submit MAP applications must be processed under MAP. See Chapter 2.7.D for additional guidance.
- B. Project Analysis. Lenders must provide an analysis with their applications which provides details about the sizing of the Section 223(a)(7) mortgage consistent with this guidance and a Sources and Uses statement consistent with such mortgage sizing calculations. The following may serve as an example of the content and presentation of a submitted Project Analysis:

The following is an example of a sample transaction – the data shown is for illustration purposes only

Section 223(a)(7) - Project Analysis - Mortgage Sizing and Sources and Uses Worksheet				Page 1
To complete the worksheet, fill in only the blue cells.				
Project Name	Oak Tree Manor Apartments	Project #	123-45678	
Project City, ST	Springfield, MO	Name of Mortgagor	Oak Tree Manor LP	
Lender	FHA Capital Mortgage, Inc.			
I. Lowest Mortgage Amount of criteria		\$ 4,800,000	Requested Amount = Lower Mtg by Choice	
1. Mortgage or Loan Amount Requested in Application	This is a manual input usually equal to the lowest of the three amounts below:		\$ 4,800,000	
2. Original Principal Amount of Mortgage(s) to be refinanced	Difference vs. request	\$200,000	\$ 5,000,000	Middle
5. Criterion 5. Amount Based on Debt Service Ratio (see calculation 5. details below)		\$1,255,700	\$ 6,055,700	Highest
10. Criterion 10. Amount Based on the cost of refinancing (see calculation 10. details below)		\$1,500	\$ 4,801,500	Lowest
<b>II. Total Requirements for Settlement</b>				
<u>Uses - Mortgageable Amounts</u>				
Current Unpaid Principal Balance of Existing Debt	\$	4,570,638		
Total Prepayment Penalty Costs	\$	137,119		
HUD approved debt to refinance via the A7	\$	-		
Critical repairs	\$	25,000		
Non critical repairs	\$	10,000		
Initial deposit to Reserve for Replacements	\$	12,000		
Fees	\$	-		
Financing fees (excluding Title&Rec., Leg&Org.)*	\$	112,800		
Title & Recording	\$	19,000		
Legal & organizational	\$	4,000		
Other permitted costs	\$	-		
(a). Total Mortgageable Uses of Cash	\$	<b>4,890,557</b>		
<u>Sources</u>				
FHA Mortgage Amount	\$	4,800,000		
Discount	\$	-		
Lender paid prepayment penalty costs	\$	48,000		
Grants & other sources to pay costs + de min Indr R4R de	\$	-		
Purchased and Transferred Reserves	\$	41,000		
(b). Total Sources of Cash	\$	<b>4,889,000</b>		
Note: net proceeds to pay borrower costs: \$ 4,848,000				
<u>Cash Requirement Calculation</u>				
(c)=(a)-(b). Mortgageable Uses of cash less Sources	\$	<b>1,557</b>		
(d). Non-mortgageable: Assurance of Completion Escrov	\$	2,000		
(e)=(c)+(d). Total Cash required	\$	<b>3,557</b>		
<b>III. Payback* calculations &amp; change in interest rate and maturity date</b>				
	P&I/mo.		Transaction costs**	\$272,919
Refi'd Debt***	\$26,443		Divided by Annual P&I savings	\$53,565
New Mortgage	\$21,979		Equals Payback Period (in years)	5.1
P&I savings (monthly)	\$4,464		New 223(a)(7) interest rate:	4.250%
			Old interest rate:	5.375%
Annual P&I savings	\$53,565		Interest Rate reduction:	1.125%
			Maturity extension (yrs.):	7.3
* Payback period for is information only; it is not a program requirement. ** Includes incremental costs to third parties not incurred or incurable under existing operation.				
Chapter 18 - Section 223(a)(7) Project Analysis example		Example derived from:	Section 223a7 Mortgage Sizing and Sources and Uses worksheet 9-24-15.xlsx	

The following is an example of a sample transaction – the data shown is for illustration purposes only

Section 223(a)(7) - Project Analysis - Mortgage Sizing and Sources and Uses Worksheet

Project Name	Oak Tree Manor Apartments	Project #	123-45678
Project City, ST	Springfield, MO	Name of Mortgagee	Oak Tree Manor LP
Lender	FHA Capital Mortgage, Inc.		

5. Amount Based on Debt Service Ratio

a. Mortgage Interest Rate		4.250000%
b. Mortgage Insurance Premium Rate		0.450000%
c. Initial Curtail Rate @ term assumed (mos.)	420	1.244728%
d. Sum of Above Rates		5.944728%
e. Net Income	\$ 400,000 x 90.0%	\$360,000
f. Annual Ground Rent	+ Annual Spec. Assmt.	
g. Line e minus line f		\$360,000
h. Line g divided by line d		\$6,055,700
i. Annual Tax Abatement	divided by	
j. Line h plus line i		\$6,055,700

Note: rounding down amount: \$86

10. Amount Based on Existing Indebtedness, Repairs, and Loan Closing Charges\*

**To Calc max mortgage based on cost, follow the steps below:**

*First, list known costs:*

Current Unpaid Principal Balance of Existing Debt	\$ 4,570,638	100.0%	Amount included for Mortgage sizing	\$ 4,570,638
Total Prepayment Penalty Costs	\$ 137,119	3.0%		
Prepmt pnly pd by lender	\$ 48,000		Prepmt pd from loan proceeds (calc't'd)	\$89,119
De min. R4R dep by lender	\$ -			
Ttl. borrower costs pd by lend	\$ 48,000			
HUD approved debt to refinance via the A7	\$ -			
Amount required to pay off existing debt	\$4,707,757			
Critical repairs	\$ 25,000			
Non critical repairs	\$ 10,000			
Initial deposit to Reserve for Replacements	\$ 12,000			
Fees	\$ -			
Title & Recording	\$ 19,000			
Legal & organizational	\$ 4,000			
Other permitted costs	\$ -			
(a). Total known/fixed costs before other costs	\$ 4,729,757			
<i>List known non FHA-loan sources that offset costs:</i>				
Grants & other sources to pay costs	\$ -			
Purchased and Transferred Reserves	\$ 41,000			
(b). Sum of known amounts to offset costs	\$41,000			
(c)=(a)-(b). Total known costs less known offset sources	\$4,688,757			

*Second, list unknowns, i.e., costs as %s of the final mortgage amount:*

FHA MIP	0.45%
FHA exam	0.15%
Financing Fee	0.50%
Perm Placement fee	1.25%
Allowance extra	0.00%
Discount	0.00%
Total of unknowns %s	2.35%
(d). 1 minus % sum above is the gross up factor	97.65%

*Third, apply gross up factor based on unknowns*

(c)/(d). Calculated cost mortgage: \$ 4,801,594

Calculated cost mortgage rounded down: \$ 4,801,500

The figures below recategorize the figures above to show a traditional cost mortgage breakdown:

a. Total Existing Indebtedness	\$ 4,659,757
b. Required Repairs	\$ 35,000
c. Other Fees	\$ -
d. Loan Closing Charges ** (see details below)	\$ 147,835
e. Sum of line a through line d	\$4,842,592
f. Enter the Sum of any Grant/Loan and Reserves for Replacement and Major Movable Equipment on Deposit	\$41,000
g. Line e minus line f (rounded down)	\$4,801,500

Note: rounding down amount: \$92 consistency chk vs. M 108 (should be \$0)

Refi'd Debt***	\$5,000,000	FHA #	123-45678
Interest Rate	5.375%	Amort. Start date	6/1/2008
Maturity date	6/1/2043		
Maturity-yrs.	35.0	Princ. Bal date	9/1/2015
Rmng. Term-mos.	333		
Calc'd amort.	-\$429,362	8.6%	Month of refi
Calc'd bal.	\$4,570,638	91.4%	87
		Year of refi (truncated)	7

Note: Repairs Escrow calculations

\$10,000	a. Non-critical repairs
20.0%	b. % escrow
\$2,000	c. \$ escrow

Note: Total knowns excluding payoff \$ 70,000

\*\*\* If a refi of a refi, describe original mortgage here:

Original Princ. Balance	Int. Rate
Maturity date	Term
Amort. start date	FHA #

Should be equal

The following is an example of a sample transaction – the data shown is for illustration purposes only

Section 223(a)(7) - Project Analysis - Mortgage Sizing and Sources and Uses Worksheet				Page 3
Project Name	Oak Tree Manor Apartments	Project #	123-45678	
Project City, ST	Springfield, MO	Name of Mortgagor	Oak Tree Manor LP	
Lender	FHA Capital Mortgage, Inc.			

**V. Condensed summary of Sources and Uses**

Sources (summary)	Amount	Uses (summary)	Amount
New Section 223(a)(7) mortgage	\$ 4,800,000	Unpaid Principal Balance of existing mortgage	\$ 4,570,638
Lender payment of all or a portion of prepayment penalty	\$ 48,000	Initial deposit to Reserve for Replacements	\$ 12,000
LOC - Borrower funding of non-mortgageable Assurance of Completion escrow	\$ 2,000	Non-critical repairs	\$ 10,000
		Prepayment Penalty (entire amount due)	\$ 137,119
		Assurance of completion escrow (non-mortgageable)	\$ 2,000
Subtotal of selected Sources	\$ 4,850,000	Subtotal of selected Sources	\$ 4,731,757
All other Sources (includes transferred reserves, contributed cash & LOCs, + other trade. prem.)	\$ 40,557	All other Uses (includes fin. fees & costs, other refi'd debt, repairs, discnts. & misc.)	\$ 158,800
<b>Total Sources</b>	<b>\$ 4,890,557</b>	<b>Total Uses</b>	<b>\$ 4,890,557</b>

**V. Financing Charge details for Cost Based Criterion 10. mortgage and the Actual mortgage**

*Note that the actual mortgage may be equal to the Cost Based Criterion Mortgage if this is the maximum permitted mortgage):*

Fees for the <u>Criterion 10 mortgage</u> of \$ 4,801,500	Fees based on the <u>actual mortgage amount</u> of \$ 4,800,000																																																												
<p>** Financing Charges based on fees shown as %s of the mortgage amount listed in Section II, and certain "knowns" per <u>cost-based mortgage</u> calc't'd. per Criterion 10. above.</p> <table style="width: 100%; border-collapse: collapse;"> <tr><td>FHA MIP</td><td style="text-align: right;">\$ 21,607</td><td></td></tr> <tr><td>FHA exam</td><td style="text-align: right;">\$ 7,202</td><td></td></tr> <tr><td>Financing Fee</td><td style="text-align: right;">\$ 24,008</td><td>Financing fees</td></tr> <tr><td>Perm Placement fee</td><td style="text-align: right;">\$ 60,019</td><td>Subtotal:</td></tr> <tr><td>Allowance extra</td><td style="text-align: right;">\$ -</td><td style="text-align: right;">\$ 112,835</td></tr> <tr><td>Discount</td><td style="text-align: right;">\$ -</td><td></td></tr> <tr><td>Title Recording HUD</td><td style="text-align: right;">\$ 19,000</td><td></td></tr> <tr><td>Legal &amp; org</td><td style="text-align: right;">\$ 4,000</td><td></td></tr> <tr><td>Initial dep to reserve</td><td style="text-align: right;">\$ 12,000</td><td></td></tr> <tr><td><b>Total</b></td><td style="text-align: right;"><b>\$ 147,835</b></td><td></td></tr> </table>	FHA MIP	\$ 21,607		FHA exam	\$ 7,202		Financing Fee	\$ 24,008	Financing fees	Perm Placement fee	\$ 60,019	Subtotal:	Allowance extra	\$ -	\$ 112,835	Discount	\$ -		Title Recording HUD	\$ 19,000		Legal & org	\$ 4,000		Initial dep to reserve	\$ 12,000		<b>Total</b>	<b>\$ 147,835</b>		<p>* Financing Charges based on % above and certain "knowns" per <u>actual mortgage</u></p> <table style="width: 100%; border-collapse: collapse;"> <tr><td>FHA MIP</td><td style="text-align: right;">\$ 21,600</td><td></td></tr> <tr><td>FHA exam</td><td style="text-align: right;">\$ 7,200</td><td></td></tr> <tr><td>Financing Fee</td><td style="text-align: right;">\$ 24,000</td><td>Financing fees</td></tr> <tr><td>Perm Placement fee</td><td style="text-align: right;">\$ 60,000</td><td>Subtotal:</td></tr> <tr><td>Allowance extra</td><td style="text-align: right;">\$ -</td><td style="text-align: right;">\$ 112,800</td></tr> <tr><td>Discount</td><td style="text-align: right;">\$ -</td><td></td></tr> <tr><td>Title Recording HUD</td><td style="text-align: right;">\$ 19,000</td><td></td></tr> <tr><td>Legal &amp; org</td><td style="text-align: right;">\$ 4,000</td><td></td></tr> <tr><td>Initial dep to reserve</td><td style="text-align: right;">\$ 12,000</td><td></td></tr> <tr><td><b>Total</b></td><td style="text-align: right;"><b>\$ 147,800</b></td><td></td></tr> </table>	FHA MIP	\$ 21,600		FHA exam	\$ 7,200		Financing Fee	\$ 24,000	Financing fees	Perm Placement fee	\$ 60,000	Subtotal:	Allowance extra	\$ -	\$ 112,800	Discount	\$ -		Title Recording HUD	\$ 19,000		Legal & org	\$ 4,000		Initial dep to reserve	\$ 12,000		<b>Total</b>	<b>\$ 147,800</b>	
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**VI. Details of prepayment penalty and sources of payment**

Total Prepayment Costs to be paid	\$	% of new actual mtg. amt.
Total Prepayment Costs to be paid	\$137,119	2.857%
Total prepayment pnly to be paid from mortgage proce	\$89,119	1.857%
Total prepayment pnly to be paid by lender	\$48,000	1.000%
Any de minimus lender deposit into the Res. For Repl.	\$0	0.000%

- C. Verification of existing borrower debt. The lender must verify the amount and terms, including prepayment penalties and repayment terms, of existing insured mortgage debts and any other secured or unsecured debt of the borrower.
1. The application should include a copy of the mortgage note and documents evidencing other indebtedness.
  2. The lender should compare the mortgage debt information submitted to the lender with information in the project's financial statements and the title search report. Any discrepancies should be explained in writing by the owner. Since the owner is prohibited from encumbering the project without HUD's written approval, if the owner is in violation of this provision, the violation should be brought to the attention of the Director of Asset Management in the HUD Regional or Satellite Office with jurisdiction.
  3. If the borrower has made a loan to fund repairs or betterments (whether or not evidenced on a HUD-approved promissory note), a determination must be made as to whether the debt is acceptable to HUD. If the debt is to be repaid as part of the 223(a)(7), it is not necessary for the debt to be on a HUD-approved form prior to closing. If the debt is to remain in place after closing to reduce cash requirements, the owner must evidence the debt on HUD-approved forms.
  4. When additional indebtedness is associated with betterments made to the project and previously financed, the borrower must provide a list of betterments financed by that indebtedness.
- D. CNA requirement. A Capital Needs Assessment (CNA) is required for all Section 223(a)(7) applications. See Chapter 5.10.D. For purposes of Section 223(a)(7) refinancings, an existing CNA may be accepted if it conforms with current guidance for acceptability per Chapter 5.10.D.1.-3., under Processing for Refinance or Acquisition, Section 223(f) and 223(a)(7) and 241(a) for Repairs and Alterations.
- E. Site visits. Site visits (by either the lender or HUD) may not be required, although in case of large or distressed loans regardless of size, a site visit by the lender (and/or HUD staff) may be appropriate and necessary.
- F. Section 202 mortgage refinancings. Section 202 projects which are refinanced with an FHA-insured loan are exempt from Section 514(g) of MAHRA under Section 514(h)(2) of that act, for as long as the first FHA refinance loan is outstanding. If that FHA loan is subsequently again refinanced, (using Section 223(a)(7) for example), that Section 514(g) exemption is no longer applicable. Thus, if the Section 8 rents were above market, a reduction of rents to market at the expiration of the contract term is required, and the underwriting of the new loan must reflect rent levels which change from current to market rate in accordance with the expiration of the contract. Such projects must be sent to the Office of Recapitalization for processing the rent reduction under the Mark to Market program.

**Example of underwriting a Section 202 project exempt under MAHRA’s mark-to-market provisions**

Assumptions:				
Original loan program			Section 202	
Examples of rent-setting requirements for loans with different refinancing histories				
	Refinanced into an insured FHA loan in accordance with MAHRA	Exempt from Section 514(g) rent adjustment?	Subsequently refinanced	Exempt from Section 514(g) rent adjustment for underwriting/loan sizing under MAP?
Loan 1	Yes	Yes - Under Section 514(h)(2)	Yes	No - Section 514(h)(2) no longer applies; adjustments would apply at the HAP contract’s expiration

- G. Ownership/Property Management Changes. The lender must verify that any changes in ownership since the endorsement of the existing loan have been properly documented and approved through Previous Participation Review (e.g., submission of Form 2530). Section 223(a)(7) applications should not be submitted until any required Previous Participation Reviews have been processed.
- H. Changes of ownership. Any changes of ownership are subject to Transfer of Physical Assets (“TPA”) procedures and must be executed separately from 223(a)(7) transactions. The borrower for the loan being refinanced must be the same borrower for the proposed 223(a)(7) loan.

**18.5 Application Requirements Checklist**

Checklist and Exhibits.  
 See Appendix for the Section 223(a)(7) Application Requirements Checklist.