

**CHAPTER 3: LENDER UNDERWRITING**

**3.1 INTRODUCTION**

The underwriting of a loan is the process by which the lender determines whether the loan is a good investment of capital. The process involves a simultaneous analysis of the creditworthiness of the borrower and the economic value of the property as an income-producing investment. If the borrower is creditworthy and the property has sufficient value under existing market conditions, the lender can enter into the loan with reasonable confidence that the investment will be a good one. The underwriting of a GRRHP loan involves the same type of feasibility analysis as the lender uses for any other loan. The only difference is that the GRRHP loan will have certain restrictions on the use of the property that must be factored in to the underwriting analysis.

- Key Topics in this Chapter**
- Lender Responsibilities
  - Lender’s Underwriting Conclusions
  - Borrower Eligibility Requirements
  - Property Requirements
  - Determining Property Value
  - Financing Terms and Lender Commitment

This chapter brings together the borrower eligibility, property, and loan requirements of GRRHP that must be a part of the lender underwriting analysis. In evaluating each transaction, the lender must use prudent underwriting standards, consistent with the best industry practices and with the requirements set forth in this chapter.

**SECTION 1: LENDER UNDERWRITING RESPONSIBILITIES**

**3.2 OVERVIEW**

Prior to requesting a loan guarantee, the lender must underwrite and approve the loan. The underwriting analysis is a detailed evaluation of key elements of borrower experience and creditworthiness, market conditions, the value of improvements, and the ability of the property to attract the rents needed to support the loan. The lender underwriting must identify and evaluate all of the factors that could affect loan performance. Such factors must be reflected in the conclusions of the underwriter detailed in the Underwriter’s Narrative. The Agency expects the lender to apply the underwriting guidelines in the same manner as if the lender were making a conventional loan for its own portfolio.

### 3.3 SUMMARY OF LENDER RESPONSIBILITIES

The lender's underwriting responsibilities can be summarized as follows:

- Review borrower's qualifications and capacity to own and operate the property in accordance with the loan terms and program requirements;
- Approve the plans and specifications for the construction of the property;
- Determine that there is a market for the project – that is, that there is demand for additional rental units of the type proposed at market rents or at the proposed rents, if higher;
- Determine the expense amounts and the amount of replacement reserves;
- Determine the appropriate debt service coverage ratio;
- Review the management plan and management agreement for the management of the property;
- Ensure that all materials prepared by outside parties such as appraisers, architects, attorneys, environmental consultants, engineers, or cost estimators are adequate for their intended purpose and comply with Agency requirements; and
- Determine the value of the property.

## SECTION 2: LENDER NARRATIVE

### 3.4 NARRATIVE REQUIREMENTS

The lender must submit a complete narrative summary of all of the factors affecting the transaction and provide supporting documentation for all decisions made in underwriting the loan. This will be submitted as part of the loan guarantee application (see Section 3 of Chapter 4). The lender is expected to identify those factors that may impact the performance of the loan. The lender's underwriting narrative must include the following elements:

#### Outline of Lenders Narrative

- Summary of Loan Request
- Financing Terms/Commitment
- Borrower/Sponsor's Qualifications
- Management Review
- Property History
- Site/Area/Neighborhood Analysis
- Improvements/Physical Needs
- Environmental Issues
- Market Analysis/Appraisal
- Income/Expense Proforma
- Valuation

- Summary of loan guarantee request, including the amount of the loan, guaranteed portion, and any subordinate financing;
- Conclusions about the borrower, including eligibility, financial capacity, and management review;
- Property history and loan purpose, including prior ownership and any outstanding financing;
- Conclusions about the property, including site and neighborhood analysis; and
- A summary of known or potential environmental concerns.
- Determination of the project's value, including market analysis, appraisal, income and expense analysis and valuation.

While the lender is expected to use their experienced judgement in making a determination of value and developing financing terms, lenders must consider the Agency underwriting guidelines contained in the following sections of this chapter in making loans for Agency guarantee.

## **SECTION 3: BORROWER ELIGIBILITY**

### **3.5 OVERVIEW**

The borrower's intentions, qualifications, and capabilities are crucial to maintaining housing that is decent, affordable, and financially sound. Lenders must determine that the borrower is financially and legally capable of meeting all program requirements and has a good record of compliance with Agency and other Federal program requirements and financial obligations. In reviewing borrower eligibility, the lender must examine the background and capabilities of all of the principals of the borrower (ownership) entity. While those principals holding management responsibilities will receive the most thorough scrutiny in terms of capacity to operate the property, all principals must be eligible in accordance with Paragraph 3.6.

### **3.6 ELIGIBLE BORROWERS**

To be considered eligible the borrower must:

- Be a creditworthy entity. Borrowers who own any other business or engage in other business activities are eligible to participate in the program. However, due to liability concerns, it is in the best interest of the borrower and the Agency for the borrower to be a single asset entity. Agency staff should encourage borrowers to create a single asset entity for each project, and inform borrowers of the potential liability risk for borrowers who own other businesses or engage in diverse business activities;

- Any borrower that has been declared in default of a loan under the GRRHP, Section 515, or other Agency housing program, must be in compliance with an approved workout plan that addresses the deficiencies. The approved workout plan must have been in place and satisfactorily performed for at least six months for the borrower to be considered eligible for an initial or subsequent GRRHP loan.
- Be able and intend to maintain and operate rental housing in accordance with program objectives and requirements;
- Be in compliance with all legal and regulatory requirements with respect to any Agency program and any other Federal debt; and
- Be a U.S. citizen(s) or legal resident(s), a U.S. owned corporation, a limited liability corporation (LLC) or a partnership in which the principals are U.S. citizens or permanent legal residents.

The lender can establish the citizenship of a borrower by examining a birth certificate or passport, or by verifying the social security number or the taxpayer identification number. If the borrower is not a U.S. citizen, the borrower must provide acceptable evidence of eligible status as a qualified alien, as listed in Exhibit 3-1.

### **3.7 INELIGIBLE BORROWERS**

Borrowers are not eligible to receive Agency guaranteed loans if:

- The borrower entity or any one of its principals has been debarred by the Agency from future participation in any USDA credit program; or
- The borrower entity or any one of its principals has defaulted on any Federal debt.

### **3.8 BORROWER TYPES**

The lender must determine that the type of borrower is appropriate to carry out the obligations under the loan and GRRHP requirements. Other than public agencies, Indian tribes, and individuals, borrowers must provide documentary evidence that they are valid legal entities, licensed to do business in the state in which the property is located and able to enter into agreements governing the loan and guarantee. The following are examples of eligible borrower types and the documentation, including any amendments, they must provide to prove their legal status for a GRRHP loan.

### Exhibit 3-1

#### Acceptable Evidence of Qualified Aliens

- *Form I-551, Alien Registration Receipt Card* or prior to 1979, *Form I-151* (for permanent resident aliens).
- *Form I-94, Arrival-Departure Record*, with one of the following annotations:
  - ◇ “Admitted as Refugee Pursuant to Section 207”;
  - ◇ “Section 208” or “Asylum”;
  - ◇ “Section 243(h)” or “Deportation stayed by Attorney General”; or
  - ◇ “Paroled Pursuant to Section 212(d)(5) of the Immigration and Nationality Act (INA)” for a period of at least a year.
- If *Form I-94, Arrival-Departure Record*, is not annotated, it should be accompanied by one of the following documents:
  - ◇ A final court decision granting asylum (but only if no appeal is taken);
  - ◇ A letter from an asylum officer of the U.S. Immigration and Naturalization Service (INS) granting asylum (if application is filed on or after October 1, 1990) or from an INS district director granting asylum (if application filed before October 1, 1990);
  - ◇ A court decision granting withholding of deportation; or
  - ◇ A letter from an INS asylum officer granting withholding of deportation (if application filed on or after October 1, 1990).
- An alien who is granted conditional entry pursuant to section 203(a)(7) of the INA as in effect prior to April 1, 1980, is a qualified alien.
- A receipt issued by the INS indicating that an application for issuance of a replacement document in one of the above-listed categories has been made, and the applicant’s entitlement to the document has been verified.
- If other documents are determined by the INS to constitute acceptable evidence of eligible immigration status, they will be announced by a notice published in the Federal Register.

#### A. General or Limited Partnerships

A partnership is a business arrangement between one or more managing or general partners and one or more limited or equity partners, organized to carry out the activities related to ownership and operation of rental housing, or similar purposes. Partnerships must provide evidence of legal status in the form of a partnership agreement setting forth the terms of the business relationship. The partnership must be for a term at least equal to the term of the loan.

Lenders must verify that the partnership structure will ensure the sound ownership and management of the project over the life of the loan. Lenders should review and approve any changes in the partnership structure.

- The terms of any limited partnership agreement must require that the general partners maintain a minimum of five percent financial interest in the residual or refinancing proceeds of the partnership.
- Any limited partnership agreement must contain a clause that provides for obtaining prior consent from the lender when any of the following actions are taken:
  - ◊ Withdrawing a general partner;
  - ◊ Adding a general partner;
  - ◊ Substituting a general partner;
  - ◊ Amending the Limited Partnership Agreement or the Partnership's Certificate of Limited Partnership;
  - ◊ Selling all or substantially all of the assets of the partnership;
  - ◊ Dissolving or terminating the partnership; and
  - ◊ Borrowing funds from the general partners or third parties.

## **B. Corporations**

A corporation is a for-profit or non-profit organization created for the purpose of owning and operating rental housing, or similar purposes. Corporations must provide evidence of legal status in the form of Articles of Incorporation. Corporate owners must clearly identify the officer(s) responsible for managing the ownership responsibilities of the GRRHP project and must be in good standing with state of incorporation and where project will be built.

Non-profit corporations receive preference in ranking and are not subject to the same equity requirement as other borrower entities. Non-profits must provide evidence of their status in the form of:

- A tax-exempt ruling from the IRS designating the non-profit as a 501(c) or 501(c)(4) organization; and

- A purpose statement in Articles of Incorporation which includes a provision to provide decent housing that is affordable to low- and moderate-income persons.

### **C. Limited Liability Companies**

A Limited Liability Company (LLC) is a legal entity created to own and operate rental housing, or for a similar purpose, and that is structured to provide limited liability in the ownership of real property. LLC's must provide evidence of legal status in the form of Articles of Organization and Operating Agreements. These documents must show that:

- The authority of the members of the LLC is limited, and an authorized member who will act on the LLC's behalf has been appointed;
- The management functions of the LLC are the responsibility of a member who holds at least a five percent financial interest in the LLC;
- The LLC has agreed that any new members may only be brought into the organization with prior consent of the Agency; and
- At least one member has committed to meet the equity contribution requirements if the LLC partnership is not able to do so at the time of loan request.

### **D. Trusts**

A trust is an entity formed by a legal agreement for the purpose of owning and operating rental housing, or for a similar purpose. Organizational documents as evidence of legal status should be submitted.

### **E. Public Agencies**

Public agencies are organizations, including State or local housing finance agencies (HFA's) or public housing authorities or agencies (PHA's), organized to finance and/or own and operate affordable rental housing, or similar purposes. Public Agencies must provide evidence of legal status in the form of State or local enabling or implementing legislation, or a resolution of an official public body authorizing the creation of the agency.

### **F. Indian Tribes**

Indian tribes are legal entities recognized by the Federal government as representing the legal interests of tribal members. Indian tribes must provide evidence of legal status in the form of a certificate or other official document of recognition from the Interior Department or other authorized agency of the Federal government. A definition of "Indian tribe" is provided in the Glossary. To be eligible as an Indian tribe, this definition must be met.

## **G. Individuals**

An individual borrower is any citizen or legal resident of the United States aged 18 years of age or older who has the capacity to enter into a legal agreement to own and operate rental housing. Citizenship status of individuals is addressed in Paragraph 3.6.

### **3.9 CERTIFICATION OF LEGAL ELIGIBILITY**

The lender's attorney must review the organizational documents of the borrower, each principal that is an entity, and the organizational documents of any entity that has an ownership interest in a principal and certify that the borrower meets Agency and program requirements.

### **3.10 BORROWER EXPERIENCE AND CAPACITY**

Lenders must verify that borrowers have the experience and capacity to develop and operate the property to the standards established by the lender and the program.

Areas to be reviewed by the lender:

- The number and types of projects that the borrower has previously undertaken.
- The experience of the borrower in completing projects.
- The borrower's financial resources and management capacity to undertake the project and resolve problems that arise over the course of the loan.

The lender must be able to verify that:

- The borrower can construct or rehabilitate rental housing;
- The borrower can provide for the financially sound operation of the property over the life of the loan; and
- The borrower is legally able to enter into the necessary contracts with the builder, lender, and other parties involved in the development, financing, and operation of the property.

#### **A. Construction and Rehabilitation Experience**

The development team includes the people who will make the development of the project a reality. The development team must have experience with the type of construction involved and a history of sound performance. The lender must review and certify as acceptable each member of the development team. The core development team usually consists of the developer, architect, and contractor.



- The developer is the owner or borrower entity and the party with ultimate responsibility for getting the project completed. The developer coordinates or directs an agent to coordinate the work of other members of the development team. To demonstrate qualifications, the developer must provide a narrative description of its organization, including its history, approximate annual operating budget, staff size, resumes of key staff members, and if applicable, information about the board of directors. This narrative should also include a factual description of the developer's experience in residential real estate activities (i.e., the number and type of projects and units built, total square footage, the total cost of the projects and source of financing and pending litigation or mechanic's lien claims or contingent liabilities).
- The architect is responsible for the design of the project and for monitoring construction to ensure that it meets Agency requirements. The architect must provide a narrative about his/her firm that includes the history of the firm, professional staff, annual revenue, and experience designing similar projects.
- The contractor is responsible for construction of the project. The contractor must provide a narrative about his/her construction company including the history of the company, annual revenue, and track record in building projects of this type and size, and pending litigation or mechanic's lien claims or contingent liabilities.

#### **B. Property Management Experience**

The property manager and the management plan are crucial to the financial viability of rental housing projects. The lender must thoroughly evaluate the experience of the property manager, whether the borrower or a management agent. Particular attention should be given to:

- Knowledge of property management and marketing practices;
- Experience managing rental housing properties, with emphasis on similar properties and those managed in the same geographic area as the subject property; and
- Submission of an appropriate and comprehensive management plan and clear procedures for meeting the objectives of the plan.

If the borrower does not manage the property, a written management agreement must be executed with a qualified management company. The management agreement must clearly state the responsibilities of the management agent, the amount of management fees to be paid, and how fees are determined. If the property management agent or management plan are inadequate to the Agency, the loan will not be eligible for guarantee by the Agency.

Additional information about the elements of an acceptable management plan and management agreement are included in Chapter 8.

### **C. Financial Capacity**

The borrower must be financially stable and have sufficient resources to develop and operate the property. The borrower must demonstrate the financial resources to meet the specific requirements of the transaction.

The lender is responsible for verifying that the borrower has the cash and other marketable securities needed to close the loan and meet working capital requirements.

The borrower must meet the following equity requirements and reserve requirements.

- **Equity Requirement.** In the case of a for-profit entity, the borrower must commit equity capital in an amount equal to at least 10 percent of the total development cost. Development cost is the total cost of project construction cost, financing fees, professional fees, and profit.

In the case of a non-profit entity, the borrower must have equity capital in the amount of at least 3 percent of the total development cost.

- **Working Capital.** In addition to equity capital, the borrower must commit working capital to (1) fund construction contingencies and (2) an operating and maintenance (O&M) reserve. The Agency recommends that the construction contingency be set at 2 percent of the construction contract.

The O&M reserve will be at least 2 percent of the loan amount. Funds contributed as O&M reserve funds will be contributed from the borrower's own resources and are not to be included as part of the total development cost calculation. The funds will be deposited to the project's general operating account and will lose their identity as O&M funds. The funds will not be returned except as a "surplus cash distribution" at the end of the year and only if the requirements of paragraph 7.6 E. have been met.

In lieu of a cash contribution to the general operating account by the borrower, the lender may accept an unconditional and irrevocable letter of credit that is issued by another lending institution in an amount that is at least equal to the required O&M contribution level (2% of the loan amount). The letter of credit must remain in effect until the borrower has submitted an annual audited financial statement of the property to the lender (covering at least a 6 month period) and the lender has determined that the property is in good financial and physical condition and in compliance with the regulatory agreement. If these requirements are not met, the letter of credit must be extended for an additional year and until the requirements can be met.

## **SECTION 4: PROPERTY REQUIREMENTS**

### **3.11 OVERVIEW**

To achieve long term success, GRRHP projects must be competitive with other rental properties in their market area. Property characteristics such as location, size, amenities, and environmental conditions are important to the success of a rental housing project. Each of these characteristics affects a property's marketability, financial success, and value.

Ensuring that certain minimum property standards are met is important to maintaining the ability to remain competitive and financially viable over the long term. In evaluating property, lenders are expected to evaluate the site conditions as well as the buildings which will be constructed or rehabilitated on the site.

### **3.12 RURAL AREA DESIGNATION**

Lenders must verify that projects are located in an area that meets the Agency's definition of a rural area (see Paragraph 1.6). Lenders must contact the RHS State Office for rural area verification.

### **3.13 GENERAL SITE REQUIREMENTS**

Multifamily housing properties must be located in areas that are appropriate for residential housing and represent reasonable real estate investments. To meet this requirement, the area where the site is located must be a residential area that provides adequate services and facilities and is free from undesirable conditions. The requirements for an appropriate location are detailed below.

#### **A. Public Facilities and Services**

Sites must have necessary public facilities and services to support the needs of the tenants. The lender must ensure that necessary facilities and services exist and that they are close and convenient to the site, including:

- Central water and sewer systems;
- Schools and hospitals; and
- Shopping, medical, and pharmaceutical services.

The "close and convenient" standard may differ by area based on local transportation and population density. Factors to consider include available transportation, traffic patterns, road conditions, and terrain.

**B. Less Desirable Areas**

The Agency’s requirements for site development prohibit development in “less desirable” areas unless more attractive alternatives are not available. Such areas create unpleasant living conditions for residents and depress the value of the investment.

**Examples of Less Desirable Areas**

Examples of less desirable areas include:

- Sites adjacent to train tracks;
- Industrial areas;
- Sites with environmental concerns;
- Grain elevators and grain storage bins;
- Mobile home courts;
- Older, declining neighborhoods;
- Gas stations; and
- Car lots.

**3.14 SITE STANDARDS**

Planning for development must take into consideration topography, soils, climate, adjacent land use, environmental impacts, energy efficiency, local economy, aesthetic and cultural values, public and private services, housing and social conditions, and a degree of flexibility to accommodate changes in local needs.

**Technical Assistance on Site Standards**

Technical services such as architectural, engineering, land survey, or site planning services must be performed by professionals who are qualified and authorized to provide such services in the State where the project is developed.

Lenders must review site plans for compliance with Agency site standards.

**A. Applicable Codes**

All multifamily housing projects must observe all applicable Federal, State, and local codes, laws, local ordinances, and zoning requirements, and regulations on health and safety standards.



**B. Adequate Utilities and Infrastructure**

Sites must have infrastructure and utilities that are adequate for the needs of the site and that meet all local requirements. Ideally, the utilities should be publicly owned and have adequate capacity for the proposed development. If the project will operate its own system, lenders must approve the justification for private ownership.

**C. Grading and Drainage**

Soil and geological conditions must be suitable for the type of construction proposed. In questionable and unserved areas, the lender must obtain an engineering report with supporting data to identify all pertinent subsurface conditions that could adversely affect the structure and show proposed solutions.

#### **D. Size and Shape**

The size and shape of a site must be adequate for the proposed units as well as walks, parking, any on-site septic system, and other site improvements.

#### **E. Undesirable Physical Conditions**

Sites must not have undesirable physical conditions that create hazards or unnecessary development costs, such as:

- Rocks or soil conditions that increase development costs;
- Noise from nearby roads, airports, or factories that create unacceptable residential conditions; and
- Pollution from nearby sources that create hazardous health conditions.

### **3.15 SITE DENSITY**

Acceptable density standards will vary by market area and local codes. Because of these differences, program rules do not provide specific density standards. Instead, project density should be evaluated based on:

- Compatibility and consistency with the market and neighborhood.
- Sufficient size to accommodate necessary site features.
- Impact on total development costs and project budget.

### **3.16 NON-CONTIGUOUS SITES**

The Agency prefers to guarantee loans for single and contiguous site projects, since projects on single sites or contiguous sites are generally easier to manage and monitor than non-contiguous sites. Non-contiguous sites may be eligible for guarantee if the lender certifies that the parcels of land are:

- Located in one market area (a neighborhood or similar area where the property competes for tenants);
- Managed under one management plan and one management agreement; and
- In sufficiently close proximity to permit convenient and efficient management of the property.

### **3.17 SITE CONTROL**

At the time of closing, the borrower must have control of the housing and related land. Control means either current ownership rights to a long-term lease or a valid option to purchase or lease the land. After closing, the borrower must have a fully marketable title (fee interest) or land lease.

#### **A. Land Ownership**

The only form of ownership acceptable to the Agency is fee-simple ownership. Under this form of ownership the borrower holds a fully marketable title, which is evidenced by a deed unless received from an estate. The deed vests full interest in the property to the borrower. If proof of site control is in the form of a land purchase contract, full ownership interest must be converted to a deed prior to closing the loan.

#### **B. Land Lease**

A land lease is acceptable if the lease meets the following requirements:

- The lessor owns the land fee-simple;
- Neither the title nor the leasehold are subject to prior liens other than taxes not due and payable;
- The amount of the guaranteed loan does not exceed the market value of the property, including the value of the leasehold;
- The unexpired term of the lease exceeds the term of the mortgage by at least 25 percent; and
- Rent charged for the lease does not exceed the rate being paid for similar leases in the area.
- It is recorded in the location necessary to give notice to the public of its existence.

The lease must be in writing and must contain the following provisions:

- The lessor must authorize the proposed improvements required by the guaranteed mortgage;
- The lessor must authorize the lender and Agency the right to foreclose the guaranteed mortgage or to transfer the lease if the borrower defaults.
- The lender or the Agency are permitted to bid at a foreclosure sale or to accept deed in lieu of foreclosure;

- The lender or the Agency are permitted to sublet the property and sell the leasehold for cash or credit if the leasehold is acquired through foreclosure, deed-in-lieu of foreclosure, or borrower abandonment;
- The borrower is permitted to transfer the leasehold as part of an ownership transfer of the property, in the event of default or inability to continue with the lease; and
- The lessor gives the Agency and the lender notice of lease default and a 60 day period of time for the Agency or lender to cure the default.

The lender must submit a copy of the leasehold agreement to the RHS State Office for approval prior to loan closing. Any subsequent changes in the leasehold agreement must be approved by the Agency.

### **3.18 ENVIRONMENTAL REQUIREMENTS**

To protect the environment and to ensure the value of guaranteed loan, the Agency must undertake an environmental review. The Agency may request assistance of the lender in conducting this review. Properties must meet the Agency environmental standards in RD Instruction 1940-G and in Chapter 11.

#### **A. Lender Responsibilities Prior to Requesting Guarantee**

The Agency and the lender will incorporate into their lending practices an environmental risk management program. A major component of the environmental risk management program is the conduct of due diligence in the context of real estate transactions. The lender will ensure that due diligence is performed and the results taken into consideration through an appraisal as further detailed in Chapter 11.

#### **B. Agency Environmental Review**

The National Environmental Policy Act (NEPA) requires Federal agencies to take into consideration the potential impacts of a proposed project on the human environment and on any protected environmental resources in the vicinity of the proposed site. Therefore, prior to loan approval, obligation of loan funds, issuance of a conditional commitment, or other commitment of Agency resources, whichever occurs first, the Agency must complete a NEPA environmental review. The environmental review examines the environmental consequences of the proposed action and ensures that alternatives are developed and incorporated into the proposal to either avoid environmental impacts or to mitigate adverse effects to the environment. Further information is found in Chapter 11. The Agency conducts the environmental review process in accordance with RD Instruction 1940-G.

### 3.19 Civil Rights

Residents of housing projects benefiting from Federal assistance have the right to live in their homes free from the burden of discrimination. Consequently, for every GRRHP project, the Agency Civil Rights staff will conduct a civil rights impact analysis to determine whether the proposed project would negatively or disproportionately affect tenants by virtue of their race, color, sex, national origin, religion, age, disability, or familial status.

The civil rights impact analysis will address two areas in particular:

- The extent to which the project serves all eligible members of the community. The Agency will examine applicant plans to market the project affirmatively and to implement nondiscriminatory occupancy policies and procedures.
- The extent to which the project creates disproportionately high and adverse human health or environmental effects on minority and low income populations. The Agency will examine the project proposal to ensure that there are no factors that create adverse environmental impacts. Examples of such factors include locating the project near a sewage treatment facility, train tracks, or a farm that routinely sprays or dusts crops.

Agency guidance on the Civil Rights Impact Analysis can be found in RD Instruction 2006-P.



### 3.20 PROJECT DEVELOPMENT

All construction, rehabilitation, and use of the property must comply with applicable governmental statutes, codes, rules, and regulations.

#### A. Project Size

Rental housing properties with less than five dwelling units are ineligible for guarantee. There is no maximum number of dwelling units that renders a project ineligible. However, the market analysis, which is a part of the underwriting process, takes into account market demand and could limit project size.

#### B. Agency Construction Requirements

New construction, rehabilitation, modular and manufactured structures must meet the standards contained in RD Instruction 1924-A and the site development standards found in RD Instruction 1924-C. Unless an exception is granted for special housing needs as referenced in Paragraph 3.23, refinancing of existing housing and indebtedness is not an authorized use of guaranteed loan funds.





The lender is responsible for inspection of the project to ensure compliance with contract documents, State and local building requirements.

Acquisition with rehabilitation is permitted, subject to the following conditions:

- The portion of the guaranteed funds for acquisition with rehabilitation is limited to 25 percent of the program authority;
- Rehabilitation requires replacement or alteration of building spaces, mechanical systems, or project facilities;
- Existing structures must be structurally sound and functionally adequate prior to the start of repair work;
- Per unit rehab costs must equal \$15,000 or more; and
- When completed, the rehabilitated building(s) must be energy efficient and in “like new” condition.

### C. Federal Accessibility Requirements

GRRHP loans are subject to the Americans with Disabilities Act and the Fair Housing Act. Projects receiving interest credit or other Federal financial assistance are also subject to Section 504 of the Rehabilitation Act of 1973. These regulations must be addressed in the proposed construction plans and specifications.



- **The Americans with Disabilities Act (ADA)** (42 U.S.C. § 12131; 47 U.S.C. § 155, § 201, § 218, and § 225), addresses the civil rights of individuals with disabilities in the areas of employment, public accommodations, State and local government services, and telecommunications. The Act states that discrimination includes the failure to design and construct facilities (built for first occupancy after January 26, 1993) that are accessible to and usable by persons with disabilities. The ADA also requires the removal of architectural and communication barriers that are structural in nature in existing facilities, if the removal is readily achievable, easily accomplishable, and able to be carried out without much difficulty or expense.
- **The Fair Housing Act** (42 U.S.C. § 3601-19) requires that multifamily dwellings meet the design and construction requirements at 24 CFR § 100.205 that implement the Fair Housing Act.

- **Section 504 of the Rehabilitation Act of 1973** prohibits discrimination in Federally-assisted programs on the basis of disability. Section 504 imposes requirements to ensure that "qualified individuals with disabilities" have access to programs and activities that receive Federal funds. GRRHP lenders and borrowers are considered recipients and subrecipients under the Act. The specific requirements under Section 504 are summarized in Exhibit 3-2. Under Section 504, recipients are *not* required to take actions that create undue financial and administrative burdens or alter the fundamental nature of the program. Contractors and vendors are subject to Section 504 requirements only in the work they do on behalf of a recipient or subrecipient.

<b>Exhibit 3-2</b>
<b>Section 504 Requirements</b>
<b>Removal of Physical Barriers</b>
<p>For <b>new construction</b> of multifamily projects, five percent of the units in the project (but not less than one unit) must be accessible to individuals with mobility impairments, and an additional two percent of the units (but not less than one unit) must be accessible to individuals with sensory impairments.</p> <ul style="list-style-type: none"> <li>• The Section 504 definition of <b>substantial rehabilitation</b> multifamily projects includes construction in a project with 15 or more units for which the rehabilitation costs will be 75 percent or more of the replacement cost. In such developments, five percent of the units in the project (but not less than one unit) must be accessible to individuals with mobility impairments, and an additional two percent (but not less than one unit) must be accessible to individuals with sensory impairments.</li> <li>• When <b>rehabilitation less extensive than substantial rehabilitation</b> is undertaken, alterations must, to the maximum extent feasible, make the unit accessible to and usable by individuals with disabilities, until five percent of the units are accessible to people with mobility impairments. Alterations to common spaces must, to the maximum extent feasible, make the project accessible.</li> <li>• Accessible units must be, to the maximum extent feasible, distributed throughout projects and sites and must be available in a sufficient range of sizes and amenities so as not to limit choice.</li> <li>• Owners and managers of projects with accessible units must adopt suitable means to ensure that information regarding the availability of accessible units reaches eligible individuals with disabilities. They also must take reasonable non-discriminatory steps to maximize use of such units by eligible individuals.</li> <li>• When an accessible unit becomes vacant, before offering the unit to a non-disabled individual, the owner/manager should offer the unit, first to a current occupant of the project requiring the accessibility feature and second to an eligible qualified applicant on the waiting list requiring the accessibility features.</li> <li>• The usual standards for ensuring compliance with Section 504 are the Uniform Federal Accessibility Standards (UFAS), although deviations are permitted in specific circumstances.</li> </ul>
<b>Provide Program Accessibility</b>
<ul style="list-style-type: none"> <li>• Individuals with disabilities must be able to learn of, apply for, and participate in Federally-assisted programs or activities.</li> <li>• Special communication systems may be needed for outreach and ongoing communication (e.g., Telecommunications Devices for the Deaf (TDD), materials on tape or in Braille, or disabled-accessible locations for activities and meetings).</li> <li>• Policies and procedures must be non-discriminatory (e.g., housing providers may not ask people with disabilities questions not asked of all applicants, screen individuals with disabilities differently, or assess an individual's ability to live independently).</li> </ul>
<b>Make Employment Accessible</b>
<ul style="list-style-type: none"> <li>• Employers must not discriminate.</li> <li>• Employers must remove physical and administrative barriers to employment.</li> <li>• Employers must make reasonable accommodations for individuals with known disabilities (e.g., job restructuring, providing readers or sign interpreters, or making facilities accessible).</li> </ul>
<b>Administrative Requirements</b>
<p>If recipients or subrecipients have 15 or more employees, they must:</p> <ul style="list-style-type: none"> <li>• Designate a Section 504 Coordinator; and</li> <li>• Notify program participants and employees of non-discrimination policies.</li> </ul> <p>All recipients and subrecipients must conduct self-evaluations of compliance with Section 504.</p>


## SECTION 5: FINANCING TERMS

### 3.21 OVERVIEW


The lender must ensure that the loan submitted for Agency guarantee meets specific loan requirements established in the regulation and the NOFA. The lender must follow statutory and Agency policy on eligible use of proceeds, maximum loan amounts, maximum loan-to-value ratio, and loan terms and interest rates. In addition, lenders must observe Agency guidance on parity loans and participation loans with other lenders.

### 3.22 OCCUPANCY AND RENT RESTRICTIONS

The guaranteed loan program contains two distinct features with respect to affordability of units. Lenders must ensure that loans are underwritten and that mortgage documents adequately address these restrictions.

- **Tenant Income Restrictions.** At initial occupancy, tenancy is restricted to individuals and families whose incomes do not exceed 115 percent of area median income (adjusted for family size). The tenant income restriction must be supported by a deed restriction for each GRRHP loan.
- **Rent Restrictions.** At rent up and on a continuing basis thereafter, rents on any GRRHP unit, including tenant paid utility allowances, may not exceed 30 percent of 115 percent of area median income, adjusted for family size. In addition, the average rent for the entire project, including any tenant paid utilities, may not exceed 30 percent of 100 percent of area median income, adjusted for family size. For this purpose, area median incomes adjusted for family size are published annually by HUD in the Federal Register. 

### 3.23 USE OF LOAN PROCEEDS

As a first step in determining the financing terms, lenders must determine that all of the proceeds of the guaranteed loan will be used for eligible purposes as set forth in [7 *CFR 3565.205*]. The use of Agency guaranteed loan proceeds must comply with the standards and conditions for housing and facilities in RD Instruction 1924-A and the standards for site development in RD Instruction 1924-C. To be competitive in the market, the housing developed in this program may require additional features such as dishwashers, garbage disposals, or wall-to-wall carpeting. The Agency may approve a higher level of amenities, construction, or fees if the lender certifies that such costs and features are reasonable and customary for similar housing in the market area. 

**A. Eligible Uses of Loan Proceeds**

The proceeds of a guaranteed loan may be used for the following purposes:

- New construction;
- Rehabilitation of buildings and acquisition costs when related to the rehabilitation;
- Acquisition of existing buildings, when approved by the Agency, for projects that serve a special housing need;
- Acquisition and improvement of land on which housing will be located;
- Development of on-site and off-site improvements essential to the use of the property;
- Development of related facilities such as community space, recreation, storage, or maintenance structures, except that any high cost recreational facility, such as swimming pools and exercise clubs or similar facilities, must be specifically approved by the Agency;
- Construction of on-site management or maintenance offices and living quarters for operating personnel for the property being financed;
- Purchase and installation of appliances and certain approved decorating items, such as window blinds;
- Development of the surrounding grounds, including parking, landscaping, and fencing;
- Costs associated with commercial space provided that:
  - ◊ The project is designed primarily for residential use;
  - ◊ The commercial use consists of facilities such as laundry rooms, that are considered essential and not conveniently available; and
  - ◊ The commercial space does not exceed 10 percent of the gross floor area of the residential units and common areas, and the commercial income does not exceed 10 percent of total project income, unless a higher level is specifically approved by the Agency.
- Costs for feasibility determination, loan application fees, appraisals, environmental studies, professional fees or other fees determined by the Agency to be necessary to the development of the project;

- Technical assistance to and by non-profit entities to assist in the formation, development, and packaging of a project, or formation or incorporation of a non-profit borrower entity;
- Education programs for a board of directors, both before and after incorporation of a borrower entity that will serve as the borrower;
- Construction interest;
- Relocation assistance, in the case of rehabilitation projects;
- Developers' fees; or
- Repaying applicant debts when:
  - ◊ The Agency authorizes the use of loan funds to pay debts for work, materials, land purchase, or other fees and charges before the loan closed; or
  - ◊ The Agency concurs with a determination by the lender that costs of work, fees and charges incurred prior to loan application are integral to development of the guarantee application and project.

**B. Ineligible Uses of Loan Funds**

Loan proceeds must not be used for the following:

- Specialized equipment for training or therapy;
- Student housing;
- Housing in military impact areas;
- Housing that serves primarily temporary and transient residents, such as students;
- Special care facilities and institutional type homes that require licensing as a medical care facility;
- Operating capital for central dining facilities or for any items not affixed to the real estate, such as special portable equipment, furnishings, kitchenware, dinnerware, eating utensils, movable tables and chairs, etc.;
- Payment of fees, salaries, and commissions or compensation to borrowers, with the exception of developers' fees; or

- Refinancing of an outstanding debt, except in the case of an existing guaranteed loan where the Agency determines that the refinancing is in the best interest of the government or the program. The term and amount of any refinanced loan must not exceed the maximum loan amount or term limits.

### 3.24 APPLYING SECTION 207(C) LOAN LIMITS

The loan amount must not exceed the applicable maximum per dwelling unit limitations amended by H.R. 1629, dated April 26, 2001, of Section 207(c)(3) of the National Housing Act. The limits are published by HUD, but Agency staff should contact the HUD State Office as adjustments to the limits are made for different locals. The Secretary (of HUD) may increase these limits up to an amount not to exceed 110 percent in any geographical area where the Secretary finds that cost levels so require, and up to 140 percent on a project-by-project basis where the Secretary determines it is necessary. The amount also may be increased by up to 20 percent, if necessary, to account for the cost of installation of certain energy improvements.



### 3.25 MORTGAGE TERMS

#### A. Maximum Loan Term

The lender is expected to determine the loan's repayment term. However, the repayment term cannot exceed 40 years or the remaining economic life of the project, whichever is less. Where interest rates available on shorter term loans result in lower unit rents, lenders are encouraged to make shorter, fully amortizing loans.

As a result of Public Law 106-569, dated December 27, 2000, section 538 of the Housing Act of 1949 (42 U.S.C. 1490p-2) was amended to allow the implementation of a loan guaranteed by the GRRHP, to be made for a term of not less than 25 and not more than 40 years from the date of the loan and to provide a loan amortization period not to exceed 40 years, with a final payment of the balance due at the end of the loan term. State Offices may accept requests from lenders to restructure the loan terms of prior NOFA Awards accordingly. However, the amortization of the loan may not be less than the original submitted NOFA response, with a final payment of the balance due at the end of the loan term. For example:

A lender received an invitation to submit an application based on a past NOFA response that indicated the lender and the applicant had negotiated a loan with a 30-year term and an interest rate of 200 basis points over the 30-year Treasury Bond Yield. The lender and the applicant now agree that a mortgage with a 25-year loan term and a 30-year amortization would better suit their needs. This change to the lender's NOFA response would be permissible, as would a 25-year loan term and a 40-year amortization. However, if the NOFA request was for an amortization of 40 years, the lender could not request the loan structure be changed to a loan with a 30 year amortization, and in no instance will the interest rate change.

#### B. Maximum Interest Rate

The interest rate must not exceed the maximum rate specified in the NOFA for the year the loan was obligated. The loan must bear a fixed rate of interest over the entire term.

### **C. Interest Reduction Credit**

The Agency will provide additional financial assistance for 20 percent of the loans by providing an interest credit to reduce the interest rate to the Applicable Federal Rate (AFR). In general, the interest credit will reduce the interest rate by 100 to 200 basis points. The interest credit will be paid following the January 1 of the year in which the project has reached occupancy standards, and the Loan Note Guarantee is converted to a Final Loan Note Guarantee.

### **D. Maximum Loan Amount**

The lender is responsible for determining the appropriate maximum loan amount based on, among other things, market demand, absorption period, loan-to-value limits, other sources of financing, and total project development costs. Development costs include the housing and related facilities. Lenders must determine the total development cost of the property by reviewing proposed plans and specifications and the construction bids presented by the borrower and the builder.

#### ***1. Determining Maximum Loan-to-Value***

For borrower entities that are not State, local, or tribal government bodies, or non-profit organizations, the guaranteed loan cannot exceed 90 percent of the total development cost or property value (as determined by the lender), whichever is less. Non-profit entities and Indian tribes may borrow up to 97 percent of the lesser of total development cost or value.

Issues such as market conditions and borrower and property weaknesses should alter the loan-to-value limit. For example, if the area in which the property is to be located is experiencing an economic downturn that is not yet reflected in comparable sales, the lender should consider a lower loan-to-value to hedge against the expected drop in property values.



## 2. *Other Financing Sources*

Projects may need additional financing to be feasible in a given market. Many GRRHP projects will include equity financing from Low Income Housing Tax Credits or will involve grants or loans from HOME funds or State or local housing assistance. In addition, some projects may involve secondary bank financing to cover costs not eligible or feasible under the guaranteed loan program. This additional capital should result in a lower loan-to-value ratio on the GRRHP loan.

## SECTION 6: DETERMINING PROPERTY VALUE

### 3.26 OVERVIEW

The lender is ultimately responsible for determining the value of a property. In doing so, the lender must take into account the appraisal and all of the factors related to the borrower, property, and financing. There is not a formula that can be applied in every case, but rather a weighing of multiple factors and the unique circumstances of each property. The experience and knowledge of the lender's underwriter is key to making an appropriate determination. The underwriter determination must be clearly supported and accepted by the lender's loan committee.

The following is a discussion of the information that must be examined by the lender in determining property value.

### 3.27 CASH FLOW ANALYSIS

The lender must analyze the proposed cash flow for the property to be sure that it is reasonable and supported by information on income and expenses for similar properties. Any unique factors in the analysis must be explained. The lender must also review the borrower's estimate of future income and expenses for the property. This review should include a cash flow analysis over a 15-year period.

#### A. Operating and Maintenance Expense

The operating budget is used to project the income and expenses for the project and the net operating income (NOI) the project will have available for debt service. The operating budget must reflect the following:

- **Income Analysis.** The borrower must provide a schedule of proposed rents (exclusive of utility allowances) and any other project income. Supporting documentation must include rents, tenant paid utilities, and vacancy levels at comparable properties. Exhibit 3-3 outlines how the income side of a project budget is constructed.

**Exhibit 3-3**

**The Income Projection**

The income projection estimates rental and other income (revenue) and occupancy rates.

The project's **Effective Gross Revenue** is a function of:

- Gross Rent Potential (rents that would be collected if all units are rented and all tenants paid their rent).
- Less rent not collected due to vacancies, delays in lease-up, and bad debt.
- Plus other income from parking, laundry, commercial space, etc.

Sources of information for the development of this part of the proforma include:

- The Rent Roll (for existing properties and comparable properties) -- the rent roll is the source document for information on units occupied and vacant, rents charged and collected, bad debt, move-in and move-out dates, and so on.
- A Market Analysis (for newly constructed and substantially rehabilitated properties).

- **Operating Cost Projections.** Estimated operating expenses, including costs of maintenance, repairs, utilities, and taxes. These estimates must be based upon the specific requirements of the subject property. Borrowers should support estimates with written documentation, where possible. Exhibit 3-4 outlines how the expense side of the projected budget is constructed.

**B. Debt Service**

In determining value, lenders must consider whether the property will generate sufficient net operating income to pay debt service and provide a return to the owner. A rule of thumb for rental properties is that properties must have sufficient net income to provide a reasonable cash surplus after expenses, or "debt service coverage." Debt service coverage (DSC) is the ratio of annual net operating income (NOI) to the annual mortgage principal and interest payment. The Agency requires lenders to use a debt service coverage of at least 1.15, unless the lender justifies a lower ratio and receives Agency approval. The NOI and DSC calculations are shown in Exhibit 3-5.

**Exhibit 3-4****The Expense Projection**

The expense projection estimates the cost of operating the property; the project's total expenses are a function of:

- Rental expenses (marketing, promotions, rent concessions);
- Management costs or fees;
- Utility and maintenance costs; and
- Taxes and insurance.

Sources of information for this part of the proforma include:

- Local and State tax offices;
- Property management companies;
- Utility companies; and
- Historical records on the subject or comparable properties.

The proforma also includes the Reserve for Replacement Account. Virtually all projects must set aside a reserve to cover the costs of non-routine repairs and replacements, such as roofs, appliances, and other capital improvements. The amount of the Reserve depends upon local fixture costs, age and conditions.

**Exhibit 3-5****Net Operating Income**

Net operating income (NOI) and debt service coverage (DSC) are important terms used in underwriting a loan. Net operating income is total project income minus expenses.

$$\text{Total income} - \text{Total expenses} = \text{NOI}$$

The Debt service Coverage (DSC) is the ratio of NOI to the annual principal and interest payments on the mortgage.

$$\text{Debt Service Coverage} = \text{Annual NOI} \div \text{Annual P\&I Mortgage Payment}$$

The DSC must always be greater than 1, since cash flow needs to be more than the mortgage payment in order for the project to be feasible. For GRRHP loans, the minimum acceptable ratio is 1.15, or 115 percent. Lenders may set a higher requirement.

*Example: A project is estimated to have an annual NOI of \$103,500 and annual mortgage payments of \$90,000. The Debt Service Coverage is  $\$103,500 \div \$90,000 = 1.15$*

### 3.28 APPRAISAL

The appraisal provides a complete, accurate description of the property, the market, and an estimate of the property’s market value. The appraiser’s conclusions must be based upon and supported by market data, logical analysis, and sound professional judgment.

#### A. Appraisal Requirements

All real property appraisals associated with Agency guaranteed loan making and servicing transactions must meet the requirements contained in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 and the appropriate guidelines contained in Standards 1 and 2 of the Uniform Standards of Professional Appraisal Practices (USPAP). All appraisals must include consideration of the effect of a potential contamination from hazardous wastes and from the release of nearby hazardous substances and petroleum products on the security value of real property. This information will be made available to the appraiser through the due diligence report. Chapter 11 contains further details.



#### B. Appraiser Qualifications

The lender is responsible for selecting qualified appraisers. To be considered qualified, appraisers:

- Must be qualified to appraise rental housing;
- Be familiar with the market in which the properties are located; and
- Be licensed and certified in the State in which the property is located.

#### C. Appraisal Methods

The appraiser must provide a complete summary report, which considers the three generally accepted appraisal methods, and follow the standards identified in USPAP. Accepted appraisal methods include the **Market or Comparable Approach**, the **Cost Replacement Approach** and the **Income Approach**. The following is a brief description of each approach.

- The **Market or Comparable Approach** compares the property to sale prices of comparable properties in the area. Adjustments are made for differences in amenities, size and other factors between the comparables and the subject property.
- The **Cost Approach** determines the cost of building the project on the basis of current prices and using current standards of material and design.

- The **Income Approach** determines the current value of the property based on the present value of a stream of future income.

For program purposes, the appraiser must rely most heavily on the **Income Approach** to assess the value of the property because the property being considered for the guarantee is an income-producing property. The other appraisal methods, such as the Market or Comparable Approach, and the Cost Replacement Approach, cannot substitute the **Income Approach** for determining the value of the property.

#### **D. Appraisal Report Guidelines**

The appraisal report must include a market analysis and a narrative attachment that supports the appraiser's conclusions. Any facts or issues about the property or the market that the appraiser thinks are important to the value determination must be addressed in the appraisal report. The lender must thoroughly review the appraisal report and note any circumstances or factors that, in the lender's view, would modify the appraiser's conclusions.

#### **E. Market Study**

If a separate market study is conducted to support the appraisal it must include the material listed in Exhibit 3-6.

**Exhibit 3-6**

**Required Contents of a Market Study**

The market study must include:

1. A complete description of the proposed site, including location of the land, location of services, and their distances from the site.
2. Major employment data including: the name, location, and date of establishment of any major employers within the community; the product or service of each employer, the number of employees and salary range for each employer, and business permits issued per year for the last three years.
3. Population by year, number, and total, plus the annual increase/decrease, and percentage.
4. Population characteristics by age.
5. Household data by number, year, and number of persons per household.
6. Breakdown of households by owners and renters.
7. Households by income group.
8. Building permits issued per year for single and multiple unit dwellings.
9. Housing stock as defined by total number of units: one unit buildings, two or more unit buildings, mobile homes, and the number of these lacking some, or all, plumbing facilities (substandard housing).
10. A survey of existing rental housing including: name, number of units, bedroom mix, family or elderly type, year built, rent, vacancies, location, and amenities.
11. Number of rent-overburdened households.
12. A projection of housing demand based on:
  - (a) Household growth.
  - (b) Units constructed since the last census.
  - (c) Number of owned and rented units.
  - (d) Number of replacements.
  - (e) Number of persons in the eligible income range.
13. For proposals where the applicant is requesting low income housing tax credits (LIHTC), the applicant must provide the number of LIHTC units and the maximum LIHTC incomes and rents by unit size. This information will determine the levels of incomes in the market area which will support the basic rents while also qualifying the borrower for tax credits.