CHAPTER 7: SECURITY REQUIREMENTS *[7 CFR 3560.60]*

7.1 INTRODUCTION

Multi-Family Housing loans made by the Agency must be secured in a manner that protects the Government's financial interest in the loan. Adequate security means that the borrower has control of the land to be developed, the value of the project provides sufficient collateral for the loan, and, in cases where additional funding has been provided by other sources, the Agency maintains an acceptable lien position.

This chapter describes the requirements that protect the Agency's financial interests and outlines procedures for reviewing applications and appraisals to ensure that the Agency obtains adequate security for Multi-Family Housing project loans.

7.2 ADDRESSING SECURITY REQUIREMENTS DURING THE ORIGINATION PROCESS

Security requirements are addressed throughout the loan application process.

- During Stage 1, the application provides evidence that the applicant will control the land prior to closing. Also, for projects with participation loans, a participation agreement is negotiated, establishing the Agency's lien position.
- During Stage 2, the security value of the property is established through the appraisal.
- At closing, the borrower must provide clear evidence of control of land and execute documents establishing the Agency's lien on the property.

SECTION 1: SECURITY REQUIREMENTS

7.3 CONTROL OF LAND

To provide adequate security for the loan, a borrower must control the housing and related land. At the time of application, borrowers must provide sufficient evidence that they will have control of the land. Before closing, the borrower must own or hold a leasehold interest to the property.

A. At Time of Application

At the time of application, borrowers must be able to demonstrate that they will have control of the land at the time of closing. An application that does not provide adequate evidence of site control will be rejected. Evidence can be provided in one of three forms:

- **Proof of title or a lease interest:** If the borrower already has control of the land, then the options discussed in Paragraph B, below, are acceptable.

- **Purchase or Lease Option:** If the borrower does not yet own the property, an option to purchase or lease the property can be provided as evidence of land control. The option must be for a term long enough to process the loan (generally, at least six months, preferably, a year) and require no renewal or extension fees.

- **Letter of Intent:** If the property is being donated to the borrower, the borrower may provide a letter of intent from the donor stating that the site will be donated to the borrower and that the borrower will assume control prior to closing.

B. At Loan Closing

At loan closing, the applicant must have proof of either the title or the lease interest.

1. Ownership

The borrower must have fee-simple ownership, under which the borrower holds a fully marketable title to the property. This title is evidenced by a deed that vests full interest in the property to the borrower.

2. Lease Interest

The borrower may lease land only if it is not available for purchase (for example, land owned by a nonpublic body, state, political subdivision, public body, public Agency, or American Indian tribal lands) and the following conditions are met:

◊ A recorded mortgage has been given as security;

◊ The amount of the loan against the property does not exceed the property's estimated market value;

◊ The unexpired lease term must be at least 25 percent longer than the repayment term;

◊ The rent charged under the lease does not exceed the rent paid for similar leases in the area;

◊ The loan applicant's interest is not subject to summary foreclosure or cancellation; and

◊ The lease permits the following:

- ♦ The right to foreclose the mortgage and transfer the lease;

- ♦ The Agency to bid at a foreclosure sale and to accept voluntary conveyance of the security in lieu of foreclosure;

- ♦ The Agency to occupy or sublet the property and sell the leasehold for cash or credit if the leasehold is acquired through foreclosure, or if the Agency accepts voluntary conveyance in lieu of foreclosure, or if the borrower abandons the property; and

- ♦ The loan applicant, in the event of default or inability to continue with the lease and the loan, to transfer the leasehold, subject to the mortgage, to a transferee that will assume the program debt.

7.4 ADEQUATE SECURITY FOR THE LOAN

To ensure that the value of the project provides adequate collateral for the loan, the Agency requires that the loan be no more than the appraised value of the property or the total allowable development costs minus the borrower's equity in the project.

For further guidance on obtaining and reviewing appraisals, see Section 2.

7.5 LIABILITY

Agency loans to borrowers will establish the borrower's personal liability, except for loans to limited partnerships. Loan processing staff must make sure that the loan agreement includes appropriate language on personal liability.

7.6 ACCEPTABLE LIEN POSITION

The Agency encourages the use of funding and loans from other sources to aid in the financing of Multi-Family Housing projects. Agency loans provided to projects in conjunction with funding other than the borrower's contribution are referred to as participation loans.

The terms of participation loans must protect the Agency's security in the project. Therefore, when additional sources of funding or financing are used, the Agency will negotiate a participation (or intercreditor) agreement that establishes an acceptable lien position for the Agency. (See Chapter 6 for a full discussion of participation loans and intercreditor agreements.)

A. Acceptable Lien on Property

To protect its interest in the project, the Agency will seek first or parity lien position on the property. A junior lien position is acceptable only if it is necessary to the project and the Government's financial interests are adequately protected (see Chapter 6, paragraph 6.5 A for additional information).

B. Acceptable Lien on Project Revenue

Agency will seek first/parity lien on project revenue. Such liens provide that if the project is subject to a servicing action, the Agency has first or parity claim on project rents and other revenue. The Agency's lien position must be specified in the intercreditor agreement.

SECTION 2: ASSESSING THE VALUE OF THE SECURITY-APPRAISALS

7.7 PURPOSE OF THE APPRAISAL

High quality appraisals are key to ensuring that the Agency obtains adequate security for its loans. The appraisal serves two functions.

- The appraisal provides an objective opinion of the value of the property. The appraiser concludes the value for the real property and for each type of favorable financing involved, if applicable. Several types of subsidies, including below-market financing (e.g., Agency interest credit and non-Agency low-interest loans), low-income housing tax credits, grants, as well as project-based rental assistance and expense abatements, add value to a Multi-Family Housing property. Each type of subsidy should be thoroughly discussed, and each type of favorable financing should be separately valued in the appraisal. For loan origination, these opinions of value serve as a basis for establishing the collateral's loan value and insurable value.

- The appraisal also serves to expand on some of the information in the loan application. Factual data contained in the report, such as regional, neighborhood, site, and apartment market data, aids the reviewer in evaluating the feasibility of the project.

7.8 REQUIREMENTS FOR APPRAISALS *[7 CFR 3560, Subpart P]*

Appraisals must meet the following requirements:

- **Qualified Appraiser:** All Agency Multi-Family Housing appraisals must be written by a state certified general appraiser. Contract appraisers must be certified (or registered for Non-Resident Temporary Practice) in the state in which the subject property is located. The appraiser must have the specialized knowledge and experience necessary to be competent to appraise subsidized housing. The appraiser must understand the housing programs, value types and definitions, real and intangible property rights, use restrictions, pertinent tax considerations, and methods for valuation of various types of favorable financing involved in the appraisal of subsidized housing.

  The Agency will typically contract with qualified state certified general appraisers. However, when a contract appraiser is not available at an acceptable cost or is unable to complete an appraisal within 45 days, a qualified Agency appraiser may conduct the appraisal. An Agency appraiser must possess the same qualifications as those required for contract appraisers, except that an Agency appraiser is only required to be certified in one State or territory to perform real property appraisal duties as a Federal employee in all States and territories.

- **Standards:** All appraisals must be in compliance with the current edition of the Uniform *Standards of Professional Appraisal Practice (USPAP)* and Agency appraisal requirements, which can be found in *7 CFR 3560, subpart P,* and this chapter of the handbook, including the attachments.

- **Nondiscrimination:** The appraiser may not use factors that are discriminatory on the basis of race, color, religion, sex, disability, familial status, or national origin in conducting the appraisal and valuing the property.

- **Timing:** The appraisal will be ordered once the applicant has been determined eligible and sufficient information has been collected to enable the appraiser to value the property. This should occur at the beginning of Stage 2 of the Loan Origination process (See Chapters 4 and 5).

- **Documentation:** *Form RD 1922-7, Appraisal Report for Multi-Unit Housing,* may be used for Multi-Family Housing appraisals. *Form RD 1922-7* is equivalent to *FNMA Form 1050* and *FHLMC Form 71A*. None of these forms are compliant with *USPAP*; however, they are standard forms used in the appraisal industry for the valuation of multi-family housing. *Form RD 1922-7*, or one of the equivalent forms, or the *Uniform Commercial Industrial Appraisal Report (UCIAR)* form is acceptable. However, the form must be modified, or attachments must be added, so that *USPAP* requirements are met. Appraisers must make the following additions when using these forms.

  ◊ Identification of the type of appraisal report (e.g. self-contained, summary, or restricted use);

  ◊ Identification of the client and any intended users of the appraisal;

  ◊ Statement of the intended use of the appraisal;

  ◊ Statement of the property rights appraised;

  ◊ Statement of the type(s) of value to be concluded, including the definition(s) of the value type(s) and the source(s) of the definition(s);

  ◊ Description of the scope of work used to develop the appraisal;

  ◊ Disclosure (clear and conspicuous) of all extraordinary assumptions and hypothetical conditions; and statements that their use might have affected the assignment results;

  ◊ Description of the information analyzed, the appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;

  ◊ Statement of the use of the real estate existing as of the date of value and the use of the real estate reflected in the appraisal;

◊ Statement and explanation of any permitted departures from specific requirements of *USPAP* Standard 1 and the reason for excluding any of the usual valuation approaches;

◊ Signed certification in accordance with *USPAP* Standards Rule 2-3;

◊ Analysis of all agreements of sale, options, or listings of the subject property at the time of the appraisal and analysis of all sales of the subject property that occurred within the 3 years prior to the effective date of the appraisal;

◊ Inclusion of prospective value (when this is the assignment, for proposed developments of real property), with the effective date of the appraisal being subsequent to the report date and based on the estimated date of completion of the proposed or on-going construction; and

◊ Estimation of reasonable exposure time, when market value is to be concluded.

An appraisal report in a narrative format, in lieu of a form report, is also acceptable, provided it complies with *USPAP* and Agency appraisal requirements. A narrative appraisal report is not required to have an attached *Form RD 1922-7*. See *7 CFR 3560.753(c)(2)* for a list of items that must be contained in a narrative report. A narrative format is more appropriate than a form format for Agency Multi-Family Housing appraisals due to the complexity of the property type, the scope of work involved, and the necessity to include a significant amount of required information on attachments to the form. When contracting for appraisals, a narrative appraisal should typically be ordered.

- **Use of Third Party Appraisals:** Rural Development may use appraisals for which it did not contract, including those obtained by participating lending institutions, state or local housing authorities, or owners/applicants. The Agency reviewer should be especially diligent in reviewing these appraisals to ensure they meet *USPAP* and Agency appraisal requirements.

7.9 VALUING MULTI-FAMILY HOUSING PROJECTS

A. Basic Components of an Appraisal

- **Types of Value:** The value type(s) that should be used in an Agency Multi-Family Housing appraisal are specific to the loan-making, loan-servicing, preservation, or disposition decision for which the appraisal is ordered. In other words, the intended use of the appraisal determines the value type(s) to be requested and reported. Depending on the decision to be made, several value types may be required in one appraisal, including the separate values of different types of favorable financing. Value types used in RHS Multi-Family Housing appraisals are defined and discussed in **Attachment 7-A**, *Value Types Used in Multi-Family Appraisals*. **Attachment 7-C**, *Specific Value Types to be Requested and Reported Based on Intended Use of Appraisal*, is a guide to be used by the State Contracting Officer, in consultation with the State Appraiser, to determine which value types to request in the appraisal Statement of Work (SOW) and Request for Quote (RFQ).

- **Property Rights Appraised:** The appraiser is required to state the property rights being valued. **Attachment 7-B**, *Property Rights Valued*, provides guidance on this issue.

- **Highest and Best Use Analysis:** "Highest and Best Use" is defined by the 4th Edition of *The Dictionary of Real Estate Appraisal* as "the reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productivity." The appraiser must conclude the Highest and Best Use of the subject site as though vacant and for the subject property as improved, if improvements have been made.

- **Approaches to Value:** Multi-Family Housing appraisals may contain one, two, or three approaches to value, as described below, depending on the specific assignment.

  ◊ The Cost Approach is a set of procedures through which a value indication is derived for a property by estimating the current cost to build a proposed structure or construct a reproduction of (or replacement for) an existing structure, including an entrepreneurial incentive, deducting depreciation from the total cost, and adding the estimated land value.

  ◊ The Sales Comparison Approach is a methodology by which a value indication is concluded by comparing the property being appraised to similar properties that have been sold recently, then applying appropriate units of comparison and making adjustments to the sale prices of the comparables based on the elements of comparison. This approach may be used to value improved properties, vacant land, or land being considered as though vacant.

  ◊ The Income Approach is a set of procedures through which an appraiser derives a value indication for an income-producing property by converting its anticipated benefits (cash flows and reversion) into property value. This conversion can be accomplished using direct capitalization or yield capitalization. Direct capitalization is a method used to convert an estimate of a single year's income expectancy into an indication of value in one direct step, either by dividing the income estimate by an appropriate rate or by multiplying the income estimate by an appropriate factor. Yield capitalization is a method used to convert future benefits into present value by discounting each future benefit at an appropriate yield rate (discounted cash flow) or by developing an overall rate that explicitly reflects the investment's income pattern, value change, and yield rate.

- **Reconciliation:** In all Agency Multi-Family Housing appraisals, each of the approaches to value should produce a value indication that is reasonably consistent with the others. Industry convention specifies that the results should not vary by more than 10 percent. Any variance of more than 10 percent between value indications from any two approaches to value must be reasonably justified in the reconciliation section of the report.

B. Valuation of Favorable Financing

Multi-layered financing, involving multiple financing sources, has become the norm in the building and rehabilitation of affordable housing. Favorable financing is offered to developers of subsidized housing to offset external obsolescence that results from a weak apartment market and/or restrictions placed on the properties by the financing sources. Several types of favorable financing can be used to develop Section 514 and Section 515 projects, including Section 514 and Section 515 direct loans with interest rates as low as one percent, low-interest loans from non-Agency sources, tax-exempt bond financing, tax credits, and grants.

When determination of *market value, subject to restricted rents,* is part of an appraisal assignment, all favorable financing in place at the time of the appraisal must also be valued, but separately from the real property. Favorable financing is valuable to the developer/owner, and an appraiser can calculate the value of each type of favorable financing. When favorable financing is involved, the appraisal report must contain a narrative identifying each source of financing. The amount and terms of each type of favorable financing must be described, and each type of favorable financing must be valued separately from the *market value, subject to restricted rents*. The appraisal SOW should specifically request each value type required, including the value(s) of each type of favorable financing.

Valuation of "interest credit subsidy" from Section 514 and Section 515 direct loans must be consistent with **Attachment 7-H**, *Guide for Valuation of Interest Credit Subsidy*. The methodology presented in **Attachment 7-H** can also be used to calculate the value of low-interest loans from non-Agency financing sources.

7.10 THE APPRAISAL PROCESS—ROLES AND RESPONSIBILITIES

To ensure that appraisals used by the Agency are of consistently high quality, each office should have standard procedures for requesting, writing, and reviewing appraisals. Several different actors play key roles in this process. These procedures and roles are outlined below. Additional detail is provided in the following paragraphs.

A. The Appraisal Process

The appraisal process involves several steps:

- **Step 1:** Request the appraisal. The Loan Originator requests an appraisal. After an applicant has been determined to be eligible, the Loan Originator should submit to the appraisal staff the information needed to complete the Statement of Work (SOW) and the Request for Quote (RFQ) for the appraisal. It is the responsibility of the State Contracting Officer to write a SOW and an RFQ when contracting for appraisals that are consistent with the instructions in this chapter. The State Contracting Officer should consult with the State Appraiser when writing the SOW and the RFQ to ensure that Agency appraisal requirements and information necessary to complete the assignment are accurately conveyed to the appraiser. It is recommended that the State Appraiser act as the Contracting Officer's Representative (COR) in the contracting aspect of the appraisal process. This may involve actually writing the appraisal SOW and RFQ.

The State Contracting Officer or State Appraiser can use **Attachment 7-D**, *Standard Statement of Work (SOW) for Multi-Family Housing Contract Appraisals*, as a template in writing an appraisal SOW. It is intended as a guide that should be modified when contracting for a specific appraisal assignment. This standard SOW lists the Agency's requirements for a typical complete appraisal.

The State Appraiser should provide all of the appraisal information that is necessary to enable the State Contracting Officer to write a complete RFQ. **Attachment 7-E**, *Appraisal Information Sheet (Example), Attachment to SOW*, should be used as a template for this purpose. The RFQ must contain adequate information regarding the scope of work of the appraisal assignment to enable the contract appraiser to make an appropriate quote.

Attachment 7-F, *Appraisal Data Package Checklist*, is a list of data that the Agency should provide to the appraiser at the time of the assignment. Appraisal staff may establish a standard procedure for collecting this information. It is not necessary for all the items in this list to be collected before the assignment is made, but the appraisal data package should be as complete as possible.

The appraiser should be provided with instructions for accessing, via the internet, *7 CFR 3560, subpart P,* and this chapter of the handbook, including the attachments, along with the SOW and data package, at the time an appraisal assignment is made.

- **Step 2:** Select an appraiser. Appraisal staff, working with the contracting staff, selects an appraiser. In most cases, the Agency relies on contract appraisers to perform appraisals. The process for selecting contract appraisers is described in RD Instruction 1922-B, Exhibit C. Establishing and maintaining a list of qualified appraisers who consistently deliver high quality appraisals is one of the keys to a successful appraisal system.

- **Step 3:** Discuss the SOW. A representative of the Contracting Officer (typically the Staff Appraiser or the Loan Originator) will discuss the contract SOW with the contract appraiser and then give permission to proceed with the appraisal.

- **Step 4:** Perform the appraisal. The appraiser performs the appraisal in accordance with the contract SOW, Agency appraisal requirements, and *USPAP*. The Staff Appraiser should be available to answer questions and provide property contacts and required data during the course of the appraiser’s assignment. The appraiser is required to notify the Agency as soon as possible if the delivery deadline will not be met.

- **Step 5:** Review the appraisal. A Rural Development State designated Appraiser/Reviewer performs a technical review of the appraisal to ensure it is acceptable. An appraisal review report that is compliant with *USPAP* Standard 3 and Agency review requirements must be written and filed for every Multi-Family Housing appraisal review, unless the appraisal was performed by a State Appraiser. Paragraph 7.13 describes the appraisal review process.

- **Step 6:** Analyze the results of the appraisal. The Loan Originator analyzes the results of the appraisal. Once the appraisal is deemed acceptable, the Loan Originator can use the results to make the value determinations needed to make a decision regarding the applicant's proposal. Paragraph 7.14 provides a full description of this analysis.

B. Roles and Responsibilities

The appraisal review system involves staff from the State and National Offices. A description of key staff responsibilities follows. Note that in some offices, roles may overlap. For example, an office may have only one appraiser who serves as the Senior Appraiser as well as Staff Appraiser.

- Loan Originator. The Loan Originator is responsible for requesting the appraisal and for reviewing it to make determinations in the loan approval process. The Loan Originator will use the appraisal to determine the loan amount, the insurance amount, and the overall feasibility of the project.

- Senior Appraiser. The Senior Appraiser is charged with maintaining acceptable appraisal quality within the state. Appraisals must meet industry standards and Agency and *USPAP* requirements. The Senior Appraiser is appointed by the Leadership Designee and should be a state certified general appraiser qualified to write and review appraisals of subsidized apartment properties. (See *7 CFR 1922.6 and 1922.7*). Senior Appraiser duties include the following:

  ◊ Oversee the review of appraisals. The Senior Appraiser should supervise the work of staff appraisers and review a sample of the appraisals to ensure the overall quality of work. The Senior Appraiser may conduct both desk and field reviews.

  ◊ Perform appraisals. The Senior Appraiser will perform appraisals on an as-needed basis when contract appraisers are not available.

  ◊ Provide program orientation to contract appraisers. The Senior Appraiser must hold occasional orientation sessions to educate contractors and potential contractors about Agency appraisal policies and procedures.

- Staff Appraiser. The Staff Appraiser must be properly trained and possess the appropriate education and experience to perform technical appraisal reviews and conduct appraisals as needed. The person should be a state certified general appraiser, certified in the state where the duty station of the appraiser is located, or be working toward certification (see *7 CFR 1922.6 and 1922.7*). Under the supervision of the Senior Appraiser, Staff Appraisers will:

- ◊ Conduct desk and field reviews of contract appraisals for compliance with the SOW, Agency policy, and *USPAP*.
- ◊ Manage appraisal contracts; and
- ◊ Conduct appraisals as needed. If the Staff Appraiser is not a state certified general appraiser, any in-house appraisal written by the Staff Appraiser must be reviewed and signed by an Agency Senior Appraiser.

- State Appraiser. State Appraiser, as the term is used in this handbook, refers to both Senior Appraisers and Staff Appraisers.
- Contracting Officer. The Contracting Officer coordinates the contractual arrangements with the contract appraiser, ensuring that the contract and the selection of the contractor meet Agency requirements.
- National Office. The National Office may request to review a sample of appraisals on a periodic basis to provide general oversight of the appraisal process. Quality reviews and regular training of State Appraisers by the National Office Review Appraiser will be performed to help ensure consistent procedures nationally.

7.11 SELECTING AN APPRAISER

The Appraiser must be selected following Agency contracting requirements. This may be achieved using a Blanket Purchase Agreement or a request for contract services.

A. Blanket Purchase Agreement

A Blanket Purchase Agreement (BPA) allows the Agency to maintain a list of eligible contractors that can be engaged at any time. Regarding the BPA list of approved appraisers:

- The Contracting Officer should develop a BPA list in accordance with Agency contracting procedures.
- When a contractor is needed, the Staff Appraiser can contact an appraiser on the BPA list. At this time, the Staff Appraiser should:
  - ◊ Confirm that the contractor's price for the appraisal is within an acceptable range (based on experience with local costs).
  - ◊ Confirm that the appraiser can complete the appraisal within the required timeframe (see paragraph C below).

- If the appraiser cannot meet these two criteria, the next appraiser on the list should be contacted, and the process should be repeated. When using the BPA list, appraisal staff should make full use of all the names on the list. It is a good practice to rotate through the list to offer different appraisers the chance to perform the contract appraisal each time an appraisal is needed.

B. Request for Contract Services

The Agency may obtain appraisal services through a request for contract services. In this case, contracting staff will solicit bids for services and select the lowest responsive bid in accordance with standard Agency contracting procedures. The Contracting Officer will use the Statement of Work, developed by the appraisal staff, as the basis for the bid solicitation and the contract.

Once a contractor is selected, the Contracting Officer should arrange a post-award meeting with the contractor as described in paragraph 7-12.

C. Time frame for Completion of Appraisals

A key criterion for selection of an appraiser is the proposed delivery date. Completion must not exceed 45 days from the date of assignment to the contractor. If the contractor indicates that this time frame is not acceptable, another contractor or a Staff Appraiser should conduct the appraisal.

If, for reasons beyond the control of the appraiser or the Agency, the appraisal cannot be completed in that time frame, the Contracting Officer may grant an extension of up to 30 days.

7.12 WORKING WITH THE APPRAISER

A. Post-Award Conference with the Appraiser

Before authorizing the contractor to start work, the Contracting Officer's Representative (COR) should discuss the contract SOW with the appraiser to ensure that the work to be performed is well understood. This may be done by telephone or in a face-to-face meeting. Following the discussion, the COR must provide the appraiser with the following items:

- Appropriate forms. The appraiser should be provided with *Form RD 1922-7*, *Appraisal Report for Multi-Unit Housing* (or an industry equivalent) and *Form RD 1924-13*, *Estimate and Certificate of Actual Cost*, if appropriate for the appraisal assignment.

- Statement of Work. The SOW should include all the information that the appraiser needs to determine the scope of work of the appraisal assignment. This includes information on the purpose and intended use of the appraisal as well as all pertinent property information. See paragraph B below for a complete description of the information included in the SOW.

- Agency appraisal regulations and instructions. The appraiser should be provided with instructions for accessing, via the internet, *7 CFR 3560, subpart P,* and this chapter of the handbook, including the attachments.

- Appraisal data package. A data package containing as many items from the Appraisal *Data Package Checklist* (**Attachment 7-F**) as possible should be provided to the appraiser.

- *Handbook Letter 107 (3560), Notice to Proceed or Task Order Letter*. This permits the contractor to begin work on the appraisal. **Attachment 7-G**, *Sample Transmittal Letter*, should be used as a template by the Contracting Officer in writing a letter of engagement to the appraiser.

B. The Statement of Work

The SOW must provide all available information needed by the appraiser to conduct a high quality appraisal. A sample SOW is provided as **Attachment 7-D**, *Standard Statement of Work (SOW) for Multi-Family Housing Contract Appraisals*. A good SOW will describe:

- The intended use of the appraisal. The SOW should describe the Multi-Family Housing program and explain how the Agency intends to use the appraisal. For example, if the appraisal is for a loan on a new project, the SOW should state that the appraisal will be used to fulfill loan underwriting requirements for permanent financing of the subject property. For a prepayment-related appraisal, the SOW should state that the appraisal will be used to establish the market value of the property, which is to be considered in making an incentive offer to preserve the property as affordable housing.

- The types of value required. The SOW should specify the value types required in the appraisal. **Attachment 7-C**, *Specific Value Types to be Requested and Reported Based on Intended Use of Appraisal*, should be used to determine the value types that will be requested in the SOW.

- Required submissions. The SOW should specify the number of copies to be delivered, the address (es) to which the reports should be sent, and the deadline for delivery. The number of copies depends on the number of parties involved in the project—these may include an interim lender or another federal or local agency (e.g., a local housing authority if tax credits or HOME funds are involved). Each party involved should be addressed in the appraiser's letter of transmittal and identified as an intended user of the report.

- Background Information. The SOW must include all appraisal and property information needed to complete the appraisal. Appraisal information includes the appraisal type (complete or limited), the report type (self-contained, summary, or restricted use), and the appraisal format (narrative or form). Property information includes property contact(s), property type, property status (existing or proposed), property interest appraised, property owner, property name and address, property description, and project financing. **Attachment 7-E**, *Appraisal Information Sheet (Example), Attachment to SOW*, should be completed and provided to the appraiser at the time the assignment is made.

C. Paying for Appraisals

- Before a contract appraiser is paid, a Staff Appraiser must review the appraisal for consistency with the contract's SOW and compliance with *USPAP* and Agency appraisal requirements as described in *7 CFR 3560, subpart P*, and this chapter of the handbook, including the attachments. If the appraisal is acceptable, the Staff Appraiser should submit the request for payment on *Form RD 838-B, Invoice Receipt Certification*. Instructions for payment of contracts are found in RD Instruction 2024-A, and Exhibit D.

- If the appraisal is deficient, the reviewer must inform the appraiser of the deficiencies prior to payment. If the deficiencies are not addressed, the reviewer must return the appraisal report and a copy of the review comments to the appraiser. The Senior Appraiser should schedule a meeting with the contractor and the Contracting Officer to discuss the appraisal and contract terms. All contractual actions taken by the Agency must be through the Contracting Officer and comply with the Federal Acquisition Regulations (FAR). Continuation of the contract will be based on the contractor's ability to meet or exceed the conditions of the contract SOW.

7.13 AGENCY REVIEW OF THE APPRAISAL

All Multi-Family Housing appraisals that were not written by an Agency certified general appraiser must be reviewed by an Agency certified general appraiser. This is to ensure that the appraisal is consistent with the Statement of Work and complies with *USPAP* and Agency requirements. The State Appraiser must write and file a technical appraisal review report that complies with *USPAP* Standard 3 and Agency appraisal review requirements.

The reviewer should take the steps described below. If the review identifies errors and/or deficiencies in the appraisal, the reviewer must inform the appraiser of the errors and/or deficiencies.

- **Step 1:** Review for Completeness. Review the appraisal for completeness using a checklist to ensure that all of the essential elements of a complete appraisal, as required by *USPAP* and the Agency, have been included in the report.

- **Step 2:** Review for Reasoning. Confirm that the analyses, opinions, and conclusions in the appraisal are appropriate and reasonable and that the report provides support for its conclusions. Consider whether the appraiser took all relevant information into account, such as:

  ◊ Using the correct rents for the type of value requested (e.g., restricted rents should be used for "market value, subject to restricted rents ", while market rents should be used to determine "market value");

◊ Factors that could affect the project's value such as nearby development, or environmental, zoning, or encroachment issues;

◊ Market information, including local rents and sales;

◊ Population trends and other demographic data; and

◊ Future area development plans.

- **Step 3:** Review for Value(s) of Favorable Financing. There are several types of favorable financing that must be discussed and valued in the appraisal of subsidized Multi-Family Housing properties. These include interest credit subsidy from USDA Section 514 and Section 515 direct loans, low-interest loans from non-Agency sources, tax-exempt bond financing, tax credits, and grants. Each type of favorable financing must be valued separately from the restricted real property. Check the appraiser's calculation of value for each type of favorable financing. See **Attachment 7-H**, *Guide for Valuation of Interest Credit Subsidy*, for guidance on the correct method to calculate the interest credit subsidy value.

- **Step 4:** Review for Overall Conclusion. Determine whether the final value conclusions in the appraisal report are reliable.

◊ Has the appraiser provided conclusions of the subject property's value using all applicable approaches to value?

◊ Have the value indications derived by each of the approaches to value been adequately reconciled? If the approaches do not yield a consistent value, has the appraiser provided an adequate explanation?

The reviewer must make one of four possible dispositions of the appraisal in the review report: (1) the appraisal is accepted; (2) the appraisal is accepted as revised by the appraiser; (3) the appraisal is accepted as modified by the reviewer; or (4) the appraisal is rejected. The reviewer must comply with the Record Keeping section of the Ethics Rule of *USPAP* and keep, or have access to, a copy of the review report for at least 5 years. A copy of the appraisal review report should be filed with the appraisal in the loan docket.

7.14 RELEASE OF APPRAISALS

Multi-Family Housing appraisals procured by the Agency will be released to owners/ applicants, from their own files, upon their request. (See *7 CFR 3560.752(d)*.)

A. Freedom of Information Act

The Freedom of Information Act (FOIA) does not prohibit the release of Multi-Family Housing appraisals ordered by Rural Development to owners/applicants, from their own files. This is because the disclosure is necessary to effectively carry out a governmental purpose. The governmental purpose in this case is to give owners/ applicants an opportunity to review their appraisals and identify any errors or deficiencies that are material to value in order to facilitate Rural Development's administration of its affordable housing programs. If an owner/applicant requests a copy of a Multi-Family Housing appraisal from his/her file, this request should *not* be treated as a FOIA request. The appraisal will be released to the owner/applicant according to the following procedures.

B. Steps in Release of Appraisals

- **Step 1:** Write a cover letter. The letter should be addressed to the owner/applicant that requested a copy of the appraisal. **Attachment 7-J**, *Cover Letter for Released Appraisal*, can be used as a template. The cover letter should identify the appraisal, provide contact information for the State Appraiser who reviewed the appraisal, and inform the owner/applicant that they may contact the reviewer to discuss the appraisal.

- **Step 2:** Redact the Appraisal. The Rural Development Office must determine if the appraisal report contains operating expense information of subsidized apartments, other than the subject property, that are administered by Rural Development that was provided to the appraiser by the Agency. If so, the names and addresses of the expense comparables must be blackened out before the appraisal is released. Qualified personnel, like the State Appraiser, must ensure that the names and addresses of the expense comparables are deleted while those of the rent comparables and sales comparables are preserved in the report. This expense data is proprietary information that belongs to the owners of apartments that possibly compete with the subject property.

- **Step 3:** Mail, or allow access to, the appraisal. After the names and addresses of any expense comparables provided to the appraiser by the Agency have been removed from the appraisal report, the owner/applicant may either review a copy of the redacted appraisal report at the Agency Office, or a copy of the redacted report can be bound and mailed, along with the cover letter, to the owner/applicant.

When contracting with fee appraisers, the SOW should instruct the appraiser to identify Rural Development as the client of the appraiser and identify both Rural Development and the owner/applicant as "intended users" of the appraisal in the appraisal report. Identification of "intended users" in appraisals is a requirement of *USPAP* Standard 2 and will ensure that the appraiser does not object to the Agency releasing the appraisal to the owner/applicant.

The Rural Development State Appraiser will make the final disposition of the appraisal. Although the disposition concluded in the appraisal review report may be provided to the owner/applicant, the review report itself is confidential, intended only for the internal use of the Agency, and will not be released.

When the purpose of the appraisal review includes the reviewer developing and reporting an independent opinion of value about the subject property of the work under review, that opinion is an appraisal. The appraisal review report then also becomes an appraisal report.

Appraisals will be released to owners/applicants, from their own files, upon their request, but appraisal review reports, including those that contain appraisals, will not be released. The FOIA Officer in the State Office should deny access if a written FOIA request for an appraisal review report is received. Exemption 5 under the FOIA, 5 U.S.C. 552(b)(5), *deliberative process privilege*, should be cited.

7.15 EVALUATING THE RESULTS OF THE APPRAISAL

The appraisal is a critical document in the underwriting process. It gives the Loan Originator information about the subject property's region, neighborhood, market, and value and thereby aids the underwriter in loan-making decisions. When evaluating the results of the appraisal, the Loan Originator will go back to the underwriting questions outlined in Chapter 5:

- Is the project eligible?
- Is the project economically feasible?
- Are the costs reasonable?
- Are the Agency's interests secure?

See Chapter 5, Section 2 for a full discussion of these underwriting criteria.

A. Is the Project Eligible?

The appraisal provides additional information about project eligibility.

- **Site suitability:** The appraisal documents boundary lines and zoning and notes desirable and undesirable elements in the market area and on the site. These elements should be reviewed to confirm the project's eligibility.
- **Rents:** The Loan Originator should compare the proposed basic rents for the project with the market rents provided in the appraisal. Program rules specify that basic rents in Agency projects may not exceed the standard Conventional Rents for Comparable Units (CRCU) in the market area, except under limited circumstances, as described in Chapter 3, paragraph 3.20(B). Therefore, if the appraisal shows basic rents in the project to be higher than CRCU, the project proposal must provide significant justification for an exception, or the applicant must seek additional financing to reduce rent levels.

B. Is the Project Economically Feasible?

The appraisal also provides information about the demand for affordable units and the likelihood that the property will be financially successful. This information can help the Loan Originator to make a final determination about the project's feasibility. The key items to consider include the following:

- **Vacancy rate:** The Income Approach should indicate the vacancy rate projected for the project, and the reasons for the given rate should be well documented. Vacancy rates above five percent may suggest that sufficient affordable housing is already available in the market and that the project may not have enough demand to be feasible.

- **Community growth rate:** The Loan Originator should consider whether the local population is growing or declining. A declining population may mean that new housing is not needed in the area.

- **Industry:** Do local industries provide sufficient stable employment to support this community into the future? Again, if the local economy is in decline, the area may experience a drop in the need for new housing.

- **Market rents:** Rent levels are also an indication of the need for new units. If basic rents projected for the project exceed market rents, this is an indication that the project is competing with conventional housing and that there is sufficient affordable housing in the market.

- **Capitalization rate:** The capitalization rate reflects the ratio of the projected net operating income to the concluded value of the project. The overall rate is a measure of the return anticipated by an investor in the market. Generally, the greater the risk an investor is willing to take, the higher the expected rate of return. Therefore, the Loan Originator should look at the capitalization rate as a measure of anticipated risk in the project. According to real estate industry standards, a capitalization rate of 10 percent or more suggests that investors consider the investment relatively risky. It may also indicate that there is adequate housing available at affordable rents and that there is insufficient demand for the project.

C. Are the Costs Reasonable?

The information in the Cost Approach of the appraisal can help confirm whether project costs are reasonable.

- **Highest and best use:** The appraisal should confirm that the highest and best use for the property is subsidized housing. If not, this may increase the development costs for the project.

- **Operations and maintenance costs:** The Loan Originator should examine the projected operating and maintenance (O&M) expenses in the Income Approach. They should be comparable to the O&M expenses of other subsidized projects (as verified by expense comparables and expense surveys from recognized sources such as the Institute for Real Estate Management (IREM)). For conventional properties, O&M expenses greater than 60 percent of effective gross income may indicate that the property has not been properly maintained or is not managed efficiently. However, for subsidized properties, a high Operating Expense Ratio (OER) may simply reflect relatively low income due to the property's restricted rents.

D. Are the Agency's Interests Secure?

The appraisal is ultimately an opinion of value that aids the Loan Originator in determining whether the Agency's interests are secure. In considering the project's value, the Loan Originator should look at the following criteria:

- **Appraised Value:** In examining the appraised value, the Loan Originator should compare the appraised value to the total development costs proposed by the applicant. In general, the appraised value should equal or exceed the estimated development costs to ensure that the loan is secured by the value of the property. However, in cases with capital subsidies (e.g., tax credits), total development costs usually exceed the appraised value of the real estate.

- **Value of the Land:** The Loan Originator should compare the appraised value of the land to the land value stated in the application. If they are different, the estimated total development costs may not be supported by the appraised value.

- **Insurable Value:** The Loan Originator must determine the appropriate amount of insurance for the property. The insurance is based on the insurable value of the property, which is the replacement cost new of the improvements plus an allowance for demolition. It should include direct (hard) costs, which are construction labor and materials and the contractor's profit, overhead, and general requirements. It should not include indirect (soft) costs, which are all other costs in the project, such as administrative costs, professional fees, and financing costs. The appraiser can calculate the insurable value of the property using **Attachment 7-I**, *Insurable Value Calculation*. (See Chapter 3 for a full description of the types of insurance required.)

- **Economic Life of the Improvements:** The economic life of the improvements must be sufficient to cover the term of the loan. For new construction, the economic life of the property is considered to be 50 years (for average to good quality construction), and the loan is amortized over that period. However, for existing structures, the appraiser estimates the remaining economic life of the property, not to exceed 50 years. The remaining economic life of the improvements must equal or exceed the term and amortization period of the Agency loan. If it does not, the term and amortization period of the loan must be adjusted to equal the remaining economic life of the improvements.

ATTACHMENT 7-A

VALUE TYPES USED IN MULTI-FAMILY APPRAISALS

A discussion of the various types of value used in Rural Housing Service (RHS) appraisals follows. A definition of each value type and the source for each definition is provided. These value types and definitions are acceptable for use by State Contracting Officers in writing a Statement of Work (SOW) and a Request for Quote (RFQ) when contracting for an appraisal and by appraisers in writing a Multi-Family Housing appraisal for RHS. General procedures for developing and reporting some of these value types are included.

Market Value

The 4th Edition of The Dictionary of Real Estate Appraisal includes several definitions for *market value*. The following definition from the dictionary is used by the federal agencies that regulate insured financial institutions in the United States.

"*Market value: 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:*

- *Buyer and seller are typically motivated;*
- *Both parties are well informed or well advised, and acting in what they consider their best interests;*
- *A reasonable time is allowed for exposure in the open market;*
- *Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
- *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.*"

Most appraisers and users of Agency Multi-Family Housing appraisals understand the definition of *market value* to mean the value as a conventional or unrestricted or market property. However, to avoid confusion when requesting or reporting this value type, the term "as conventional or unrestricted" should be added to the term *market value* (i.e. "market value, as conventional or unrestricted").

In an appraisal report, a *hypothetical condition* on which the *market value* is based should be clearly and conspicuously stated. The *market value* of a Section 514/515 housing project is always based on a *hypothetical condition*, which is defined by the 4th Edition of The Dictionary of Real Estate Appraisal as, "that which is contrary to what exists but is supposed for the purpose of analysis." An existing 514/515 apartment complex that is the subject of an appraisal ordered by the Agency is subsidized (restricted) at the time of the appraisal. A market value concluded for the property would be based on the hypothetical condition that the property is a conventional (market) property, which it is not. *Uniform Standards of Professional Appraisal Practice*

(*USPAP*) Standards Rules 1-2(h) and 2-2(a)(viii), (b)(viii), and (c)(viii) require the appraiser to identify and state any hypothetical conditions necessary in the assignment.

Market value should be requested by the Contracting Officer and reported by the appraiser when the intended use of the appraisal is to aid in determining:

- the appropriate amount of an equity loan as a prepayment incentive;
- the amount of an equity loan in a preservation transfer;
- a reasonable sale price, or the basis for a liquidation value, for a property in foreclosure; or
- a reasonable sale price for a non-program property.

Market Value, subject to restricted rents

A definition of *market value, subject to restricted rents*, as the term is used by RHS, derived from the definition of *market value* above, is stated as follows. *Market value, subject to restricted rents: 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:*

- *Buyer and seller are typically motivated;*
- *Both parties are well informed or well advised, and acting in what they consider their best interests;*
- *A reasonable time is allowed for exposure in the open market;*
- *Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
- *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.*

It considers any rent limits, rent subsidies, expense abatements, or restrictive-use conditions imposed by any government or non-government financing sources but does not consider any favorable financing involved in the development of the property.

Market value, subject to restricted rents, refers only to the value of the subject real estate, as restricted, and excludes the value of any favorable financing. The *market value, subject to restricted rents,* is based on a pro forma that projects income, vacancy, operating expenses, and reserves for the property under a restricted (subsidized) scenario. This restricted pro forma includes the scheduled restricted rents, a vacancy and collection loss factor that reflects any rental assistance (RA) or Section 8, and operating expenses and reserves projected for the subject as a subsidized property. Subsidized apartments typically experience higher management, auditing, and bookkeeping expenses, relative to similar conventional apartments, but often have lower real estate tax expenses.

Rural Development will provide a 3-year operating history of the subject property and the most recent operating statements for a set of expense comparables, if available, to the appraiser.

Expense comparables data is proprietary information. Therefore, if a copy of the appraisal is requested by an owner/applicant, the names and locations of the expense comparables must be redacted from the appraisal by the Agency before the copy is released. Much of this information is available on the Multi-Family Information System (MFIS). For the appraisal of a Section 8/515 project, Rural Development should provide the appraiser with a copy of the Housing Assistance Payment (HAP) contract and a contact at the agency that administers the HAP contract for the U.S. Department of Housing and Urban Development (HUD). The appraiser must consider the restrictions imposed on the subject property by both the U.S. Department of Agriculture (USDA) and HUD in concluding the *market value, subject to restricted rents*.

In the appraisal, the Income Approach for the *market value, subject to restricted rents,* is the best indication of value and should be most heavily weighted. Direct capitalization should typically be used when the subject's operation will be stable and restrictions will be in place long-term. A discounted cash flow (DCF) analysis should be used when significant net income changes are projected for the subject property over a foreseeable period. A DCF is the most appropriate method for valuing phased developments, projects that have several sources of income, and properties with short-term restrictions that will be converted to market apartments.

Using direct capitalization, the Net Operating Income (NOI) from the restricted pro forma can be capitalized using a capitalization rate derived from sales of conventional apartments that have physical and locational characteristics similar to those of the subject. A base capitalization rate is derived from these sales and then adjusted qualitatively for factors related to specific benefits and restrictions of the subject property. Use of an overall rate from the conventional market, which reflects conventional financing, is appropriate because all favorable financing will be valued separately from the *market value, subject to restricted rents,* of the real estate. This procedure, a departure from the method used by the Agency for many years, is standard appraisal practice. National appraisal firms and their clients use this as a primary method in the valuation of subsidized housing. A capitalization rate derived via this method should be supported using other accepted methods, including the band-of-investment technique, the debt coverage ratio formula, and regional investment criteria surveys.

A method that includes the use of note rate rent as Potential Gross Income (PGI) in the Income Approach pro forma to derive a value equal to the sum of the *market value, subject to restricted rents,* plus the value of the interest credit subsidy is not acceptable appraisal practice. Appraisers must not use this procedure in Agency Multi-Family Housing appraisals, and State Appraisers must not accept this procedure when reviewing appraisals.

In an appraisal concluding *market value, subject to restricted rents*, the Income Approach is the most important section of the appraisal and must be complete. Appraisers must provide good support for the income, vacancy, expense, and capitalization rate analyses within the approach. The expense analysis must be well supported by the 3-year operating history of the subject and by expense comparables. A current expense survey from RHS or a State or local housing authority should be used to provide additional support. The capitalization rate selected for the subject must be derived from the most recent sales of similar properties in the local (or nearest similar) conventional apartment market. Support for this overall rate should be provided using the methods discussed above. Rural Development appraisers performing technical reviews must not accept appraisals unless/until all Income Approach analyses are adequately supported.

The Cost Approach can be used to support the *market value, subject to restricted rents,* indication from the Income Approach, especially for new construction. The usefulness of the *market value, subject to restricted rents,* indication via the Cost Approach for existing properties more than twenty years old (typical of the RHS portfolio) is questionable due to the difficulty in estimating the three types of depreciation. However, when ordering appraisals, the SOW should require the Cost Approach for determination of *market value, subject to restricted rents*. Important information, including site value, construction costs, remaining economic life, and external obsolescence, can be extracted from this approach. Deduction for external obsolescence, which is basically calculated by capitalization of the difference between economic NOI and restricted NOI, results in a *market value, subject to restricted rents,* indication in the Cost Approach.

The Sales Comparison Approach is rarely applicable in concluding a *market value, subject to restricted rents,* due to the lack of sales of subsidized apartments in small rural markets and the difficulty of making meaningful adjustments for financing terms to the sales comparables. When ordering appraisals, the SOW should not require the Sales Comparison Approach for determination of the *market value, subject to restricted rents*.

The *market value, subject to restricted rents,* must include the value of any rental assistance (RA) available. When the subject property has RA, the appraisal must include a discussion of the Section 521 Rental Assistance Program, the number of RA units at the subject, and how RA affects the *market value, subject to restricted rents,* of the property. Rental assistance is a rent subsidy provided to owners of 514/515 projects. The renter of an RA unit is required to pay a tenant contribution toward the approved shelter cost (rent plus tenant based utilities) of the unit that is equal to no more than 30 percent of his/her income. RA is the portion of the approved shelter cost paid by the Agency to compensate a borrower for the difference between the approved shelter cost and the tenant contribution. RA usually adds value to a 514/515 project in three ways: 1) it guarantees that the scheduled base rate rent for all occupied RA units will be attained; 2) it usually increases demand for the subject's units and consequently decreases the vacancy rate; and 3) it reduces the risk of investment in the subject project by improving the durability of the income stream. Rental assistance need not be separately valued; the value of RA can be incorporated within the *market value, subject to restricted rents*. This can be accomplished within the Income Approach by taking into account the three ways that RA increases value, listed above, as follows. 1) Base rate rents should be included as Potential Gross Income (PGI) in the restricted pro forma; 2) a vacancy and collection loss factor that reflects the amount of RA at the property should be included; and 3) a capitalization rate for the subject may be adjusted downward to account for the reduced risk to the investor due to RA.

When determination of *market value, subject to restricted rents,* is part of an appraisal assignment, all favorable financing in place at the time of the appraisal must also be valued, but separately from the real property. Multi-layered financing, involving multiple financing sources, has become the norm in the building and rehabilitation of affordable housing. Favorable financing is offered to developers of subsidized housing to offset external obsolescence that results from a weak apartment market and restrictions placed on the properties by the financing sources. Favorable financing is valuable to the developer/owner, and an appraiser can calculate the value of each type of favorable financing. Several types of favorable financing can be used to develop 514/515 projects, including 514/515 direct loans with interest rates as low as 1 percent, low-interest loans from non-Agency sources, tax credits, tax-exempt bond financing, and grants. When favorable financing is involved, the appraisal report should contain a narrative identifying each source of financing. The amount and terms of each type of favorable financing should be described, and each type of favorable financing should be valued separately from the *market value, subject to restricted rents,* of the property. The appraisal SOW should specifically request each value type required, including the value(s) of each type of favorable financing.

Valuation of "interest credit subsidy" from Section 514/515 loans should be consistent with Attachment 7-H. The methodology presented in Attachment 7-H can also be used to calculate the value of low-interest loans from non-Agency financing sources.

It is emphasized that the *market value, subject to restricted rents,* includes the value of any rental assistance at the subject property but does not include the value of any favorable financing, including Agency financing. The value(s) of any favorable financing must be reported separately. The *security value* of the property, which may be calculated by an Agency Loan Originator in making a loan decision, is typically derived from the sum of the *market value, subject to restricted rents,* plus the total value of the applicable favorable loans. However, an appraisal report should conclude with the value(s) of the real estate and separate value(s) for any intangible items, including favorable financing. These values should not be added together by the appraiser because their sum does not represent the market value of the real estate in appraisal terms. Separate reporting of value(s) of favorable financing, including the value of tax credits and grants, which cannot be considered collateral for a loan is advised by *USPAP* (Advisory Opinion 14) and provides useful information about the security of the project to the Loan Originator.

"As-Is" Value

The 4th Edition of the Dictionary of Real Estate Appraisal defines *value as is* as follows. "*Value as is: the value of specific ownership rights to an identified parcel of real estate as of the effective date of the appraisal; relates to what physically exists and is legally permissible and excludes all assumptions concerning hypothetical market conditions or possible rezoning.*"

The term "As-Is" applies not only to the physical condition of the subject property at the time of the appraisal but to the legal status of the property. Therefore, the term "As-Is" should not be used with the term *market value* unless the property is a conventional or market property at the time of the appraisal. The term "As-Is" should precede the term *market value, subject to restricted rents,* when the *market value, subject to restricted rents,* of the project at the time of the appraisal is required.

Prospective Value

The term *prospective value* is defined by the 4th Edition of The Dictionary of Real Estate Appraisal as follows. "*Prospective value: a forecast of the value expected at a specified future date. A prospective value opinion is most frequently sought in connection with real estate projects that are proposed, under construction, or under conversion to a new use, or those that have not achieved sellout or a stabilized level of long-term occupancy at the time the appraisal report is written.*"

As used in Agency regulations and instructions, the term "as-improved value" refers to the value of real property after completion of proposed improvements. The Agency's intended meaning of "as-improved value" is the same as the definition of *prospective value*. However, use of the term "as-improved value" can cause confusion for two reasons, as follows. 1) The term "as-improved", as used in a Highest and Best Use analysis, refers to the subject real estate as it has already been improved at the time of the appraisal, not as it is proposed to be improved. Therefore, "as-improved value" could be interpreted to refer to the value of the subject property as it has already been improved at the time of the appraisal. 2) There is a common misconception with the use of the term "as-improved value" that this is a value based on a hypothetical condition; that is, the value of the property as if it were improved, as proposed, as of the date of inspection. Since this scenario is impossible, an "as-improved value", as of appraisal date (inspection date), is not useful. The term *prospective value* is better understood than the terms "as-improved value" and "as-complete value" by appraisers and users of appraisals and has replaced these terms in appraisal literature and common usage. Therefore, the term *prospective value* should be used when requesting or reporting a forecasted value, and the associated date of value should be the projected date of completion of construction.

Value-in-Use

The 4th Edition of The Dictionary of Real Estate Appraisal defines *use value (value-in-use)* as follows. "*Use value: the value a specific property has for a specific use; may be the highest and best use of the property or some other use specified as a condition of the appraisal.*"

Value-in-use is the type of value that should be requested in the appraisal SOW and reported in the appraisal of an on-farm labor housing project. The Cost Approach is the only applicable approach in an appraisal of on-farm labor housing. This type of property does not produce rental income, and sales of these projects are virtually non-existent. Consequently, the Cost Approach is the only approach to value that should be required in the appraisal SOW and included in the report by the appraiser.

USPAP requires a Highest and Best Use (HBU) analysis in all real property appraisals when the value type to be developed and reported is *market value*. When *value-in-use* (not *market value*) is to be concluded, *USPAP* does not require a HBU analysis and neither does the Agency. The Agency identifies the use or intended use of the subject property as farm labor housing to the appraiser. Therefore, the appraisal SOW for a *value-in-use* appraisal should instruct the appraiser to value the property as farm labor housing and not require a HBU analysis as part of the scope of work. The appraiser should explain in the report why a HBU analysis was omitted and include a *limiting condition* in the report that states the *value-in-use* is based on the specified use of the subject property as farm labor housing.

Liquidation Value

Liquidation value is defined by the 4th Edition of The Dictionary of Real Estate Appraisal as follows. "*Liquidation value: the most probable price that a specified interest in real property is likely to bring under all of the following conditions:*

1. *Consummation of a sale will occur within a severely limited future marketing period specified by the client.*
2. *The actual market conditions currently prevailing are those to which the appraised property interest is subject.*
3. *The buyer is acting prudently and knowledgeably.*
4. *The seller is under extreme compulsion to sell.*
5. *The buyer is typically motivated.*
6. *The buyer is acting in what he or she considers his or her best interest.*
7. *A limited marketing effort and time will be allowed for the completion of a sale.*
8. *Payment will be made in cash in U.S. dollars or in terms of financial arrangements comparable thereto.*
9. *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."*

Liquidation value should be requested in the appraisal SOW and reported in the appraisal when it is in the best interests of the Agency: 1) not to take a non-program property into inventory but to sell it at a foreclosure sale; or 2) to dispose of a non-program inventory property when a very limited marketing period is available. *Liquidation value* should be derived from *market value* by applying a discount extracted from the market, when possible. Therefore, *market value* should always be requested in the appraisal SOW whenever a *liquidation value* is sought.

Insurable Value

A definition of *insurable value* acceptable for use in Agency Multi-Family Housing appraisals is as follows: *Insurable value: the value of the destructible portions of a property which determines the amount of insurance that may, or should, be carried to indemnify the insured in the event of loss. The estimate is based on replacement cost new of the physical improvements that are subject to loss from hazards, plus allowances for debris removal or demolition. It should reflect only direct (hard) construction costs, such as construction labor and materials, repair design, engineering, permit fees, and contractor's profit, contingency, and overhead. It should not include indirect (soft) costs, such as administrative costs, professional fees, and financing costs.*

The term "insurable cost" is sometimes used instead of the term *insurable value* because it is based strictly on a cost estimate, not a value concluded in an appraisal. However, the term *insurable value* is more commonly used. Attachment 7-I, *Insurable Value Calculation*, is a worksheet that should be used as a guide by State Appraisers and fee appraisers contracted by the Agency in calculating *insurable value*.

ATTACHMENT 7-B

PROPERTY RIGHTS VALUED

In identifying the subject property, the appraiser must state and should define the particular rights or interests being valued. A thorough discussion is warranted in appraisals of fee simple estates subject to restrictive-use agreements and short-term leases. *Uniform Standards of Professional Appraisal Practice* (*USPAP*) Standards Rule 1-2(e)(ii) requires the appraiser to identify the real property interest to be valued.

The property interest to be valued in the appraisal of a Section 514/515 project, when the value type to be concluded is *market value*, is the *fee simple estate*. This property interest is subject to short-term leases and should therefore be referred to as the *fee simple estate, subject to short-term leases.*

A Section 514/515 affordable housing project is usually subject to a restrictive-use agreement imposed by the U.S. Department of Agriculture (USDA) Rural Development that places restrictions on the property for a specified period of time. These restrictions pertain to use, transfer, and operation of the property. They include rent limits and restrictions on tenant eligibility based on income. Additionally, when tax credit financing is involved, these properties have deed restrictions imposed by the Low-Income Housing Tax Credit (LIHTC) program. These restrictions are a type of *encumbrance*. The 4th Edition of the <u>Dictionary of Real Estate Appraisal</u> defines *encumbrance* as 'an interest or right in real property that may decrease or increase the value of the fee estate but does not prevent its conveyance by the owner. An encumbrance effects a permanent reduction in an owner's property rights, while a lien represents a claim against the owner's property rights, which may or may not become permanent. Mortgages, taxes, and judgments are liens; restrictions, easements, and reservations are encumbrances."

The property interest to be valued in the appraisal of a Section 514/515 project, when the value type to be concluded is *market value, subject to restricted rents*, is neither the *fee simple estate*, nor the *leased fee estate*, nor the *leasehold estate*. The 4th Edition of the <u>Dictionary of Real Estate Appraisal</u> defines *fee simple estate* as "absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat." Since Section 514/515 properties are encumbered with restrictive-use agreements, and sometimes LIHTC deed restrictions as well, the property interest to be valued is not the *fee simple estate*. However, the property interest to be valued could reasonably be referred to as the *fee simple estate, as restricted, subject to short-term leases.* To comply with *USPAP*, the appraiser should identify this as the property interest to be valued and provide a description of these property rights and the restrictions involved.

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ATTACHMENT 7-C

SPECIFIC VALUE TYPES TO BE REQUESTED AND REPORTED BASED ON THE INTENDED USE OF THE APPRAISAL

Value types that should be requested in an appraisal Statement of Work (SOW) and reported in an Agency Multi-Family Housing appraisal are specific to the loan-making, loan-servicing, preservation, or disposition decision(s) for which the appraisal is ordered. In other words, the intended use of the appraisal determines the value type(s) to be requested and reported. Depending on the decision(s) to be made, several value types may be required in one appraisal, including the separate values of different types of favorable financing. Specific value types that should typically be requested for each intended use, as they might be stated in the appraisal, are listed under each category. Some of the listed value types may not be required, depending on the needs of the State Office. The State Contracting Officer and Contracting Officer's Representative (COR) should use this guidance in determining which value types to request in the appraisal SOW and Request for Quote (RFQ). The State Appraiser or contract appraiser must follow this guidance when reporting values in the appraisal. The State Appraiser, when reviewing a contracted appraisal, should require the report to be consistent with this guidance.

The value types listed under each intended use described below are required by Rural Development in appraisals used by the Agency. It is the contract appraiser's responsibility to ensure compliance with the Uniform Standards of Professional Appraisal Practice (USPAP) and when Rural Development is partnering with other lender(s), the lender(s) must ensure compliance with all applicable appraisal guidelines and requirements for each funding source. This is a requirement of the Competency Rule and the Scope of Work Rule in USPAP. If Rural Development is provided written authorization from the borrower, and is included as a co-client and intended user of the report, information can be provided from Agency records to assist the appraiser in providing a credible analysis. It is expected that the applicant/borrower has properly notified Rural Development of their intent as required by 7 CFR Part 3560. Ultimately, the applicant/borrower has control over the anticipated funding sources and should be able to assist the contract appraiser with the appraisal requirements according to the anticipated funding sources.

This guidance does not require an appraisal when it is not otherwise needed and does not restrict Rural Development from requesting additional values if a need for analysis, or for any other purpose, is determined or requested.

On the following pages the user of this guidance will find;

- General Guidance for Rural Development Appraisals.
- Quick Reference of Values to Request.
- Specific appraisal guidance for each value as shown in the Quick Reference of Values to Request which can be used in the SOW.

GENERAL GUIDANCE FOR RURAL DEVELOPMENT APPRAISALS

- Rural Development typically uses only Three (3) Value Types:
  1. **Market Value** (7 CFR Part 3560.752(b)(1)(ii).
  2. **Market Value, subject to restricted rents** (7 CFR Part 3560.752(b)(1)(i), (The appraiser must consider all restrictions and report the value of intangible assets individually and separately from the real estate)
  3. **Liquidation Value** (has a shortened marketing period defined by the client, i.e. 30 days, 3 months, etc.).

  ***The value types listed above are based on a current time frame. Rural Development also uses a "Prospective Value", which uses the same definition as the valuations stated above, but based on a specified future date such as "Prospective Market Value" and "Prospective Market Value, Subject To Restricted Rents". Prospective Values are typically used when construction or improvements to the property need to be considered in the value.**

- The user of this guidance should be familiar with 7 CFR Part 3560 along with all applicable Handbooks. The information contained within is used to help apply the CFR, not replace it. They also need to know the purpose of the appraisal (new loan, determine equity, etc.). The appraiser should only use the value terminology as stated in 7 CFR Part 3560 (and emphasized in this guidance), other values would not be consistent in applying the regulations and may result in an inappropriate value.

- In a 'Market Value' appraisal, unless specifically requested to use a hypothetical condition to provide a credible appraisal for the intended use, the appraiser needs to analyze the Highest and Best Use of the property using four criteria; physically possible, legally permissible, financially feasible and maximally productive. The appraiser must consider all legal restrictions or prohibitions including, but not limited to; restricted use provisions, program restrictions, zoning and local ordinances.

- Using the hypothetical condition "as unsubsidized conventional housing" according to 7 CFR Part 3560.656(c)(1)(i) means when the appraiser develops their Highest and Best Use analysis they will not recognize any Rural Development restrictions or subsidies and must only consider the property as continued use as housing (apartments, condos, elderly, labor housing, etc.). They must still consider all other legal restrictions or benefits that apply to the property. If the appraiser determines that subsidies from other sources provide the highest and best use of the property this hypothetical condition according to 7 CFR Part 3560.656(c)(1)(i) does not restrict that use.

- When the value is "Subject To Restricted Rents" the appraiser must consider all restrictions and report the value of intangible assets (financing, tax credits, grants, etc.) individually and separately from the real estate in accordance with 7 CFR Part 3560.752 (b)(1)(i). Since intangible assets are nonphysical assets and not real estate the appraiser should never add the value of the intangible assets to the value of the real estate. Any investment values that add intangible assets or cash to the real estate value will not be accepted. The Security value should only be calculated by the Agency underwriter, not the appraiser.

- An extraordinary assumption should only be used to determine value when requesting a Prospective Value, since this is a forecast of future value. A hypothetical condition should only be used to determine value when the property qualifies for an Incentives Offers according to 7 CFR Part 3560.656. An extraordinary assumption or hypothetical condition may also be used to analyze the affects that any required changes have on a property.

- All hypothetical conditions and extraordinary assumptions must be labeled as such and must be clear and conspicuous to the reader of the report.

- Every appraisal should be done on the subject in its 'Current Physical Condition' except 'Prospective' values which usually includes construction and should be based on the estimated date that construction would be completed and occupancy stabilized.

- Intangible assets are nonphysical assets, as distinguished from physical assets such as facilities and equipment. They include rights over real property, but not rights of use and possession. In subsidized housing they include, but are not limited to, interest credit subsidies, and low-interest loans from other sources, tax-exempt bond financing, tax credits, and grants.

- Security value means the value of an asset deposited or pledged as a guarantee of the payment or fulfillment of an obligation or debt. Security value as utilized by the Agency is an underwriter's tool to assist them in the collateral requirements of a loan. The real estate value, personal property value and the intangible assets value should always be reported individually and separately in an appraisal report. The Security value does not always include every intangible asset. The Agency underwriter must determine which intangible assets are considered in the Security value.

- This guidance should not restrict Rural Development from requesting additional values if a need for additional analysis or for any other purpose is determined or requested.

- In many cases, for transfers, prepayments, rehab, etc., in utilizing QUICK REFERENCE OF VALUES TO REQUEST you should ask a few questions;

  (1) Does the property qualify for an Incentives Offer within 7 CFR Part 3560.656? Request value of property under # 3 or #4 based on the answer.
  (2) Is there an existing loan? Do we need to know the current security position of the property? Request the value under #2.
  (3) Is Rural Development or others providing any new funds or subsequent loans that may affect the value of the security? Request the values under #1.

  Other questions may apply depending on the specific intended use.

QUICK REFERENCE OF VALUES TO REQUEST

1: NEW FUNDS OR SUBSEQUENT LOANS (By Rural Development or others)

- New construction
- Rehab/repair construction

REQUEST:
"Prospective Market Value, Subject To Restricted Rents within 7 CFR Part 3560.752(b)(1)(i)". (The appraiser must consider all restrictions and report the value of intangible assets individually and separately from the real estate.)
"Prospective Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Conventional Housing". (Optional value used to analyze the affects of restrictions).

2: EXISTING LOAN

- Transfer
- Loan assumption
- Loan write-down
- Subordination

REQUEST:
"Market Value, Subject To Restricted Rents within 7 CFR Part 3560.752(b)(1)(i)". (The appraiser must consider all restrictions and report the value of intangible assets individually and separately from the real estate).

3: VALUE OF PROPERTY (Does NOT qualify for Prepayment Incentives Offers within 7 CFR Part 3560.656 Incentives Offers).

- Validation of sale/marketing price
- Equity determination
- Acquisition of property into program

REQUEST:
"Market Value, within 7 CFR Part 3560.752(b)(1)(ii)". (All restrictions and prohibitions currently existing must be considered, including Restrictive Use Provisions).

4: VALUE OF PROPERTY (Qualifies for Prepayment Incentives Offers within 7 CFR Part 3560.656 Incentives Offers).

- Validation of sale/marketing price
- Equity determination

REQUEST:
"Market value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Unsubsidized Conventional Housing in compliance with 7 CFR Part 3560.656(c)(1)(i)". (In order to use this value the property must qualify for a prepayment incentives offer within the Code of Federal Regulations).

5: VALUE FOR SALE - ELIGIBLE AS PROGRAM PROPERTY

- Maintain in program, REO's, foreclosure, etc.

REQUEST:
"Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Conventional Housing".
"Market Value, Subject To Restricted Rents within 7 CFR Part 3560.752(b)(1)(i)". (The appraiser must consider all restrictions and report the value of intangible assets individually and separately from the real estate).

6: VALUE FOR SALE - NON PROGRAM PROPERTY

- Properties leaving program, REO's, etc.

REQUEST:
"Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If a Conventional Market Property".
"Liquidation Value Premised Upon a Marketing Period of (enter days) **Days".** (Optional value, market period prescribed by USDA.)

☐ **<u>1: NEW FUNDS OR SUBSEQUENT LOANS</u> (By Rural Development or others)**

VALUE REQUIRED FOR:

- New construction
- Rehab/repair construction

APPRAISED VALUE TO REQUEST:

- ***Prospective Market Value, Subject To Restricted Rents within 7 CFR Part 3560.752(b)(1)(i).*** (Must consider any rent limits, rent subsidies, expense abatements, and restrictive-use conditions that will affect the property. All intangible assets must be evaluated individually and separately from real estate.)

AND POSSIBLY:

- ***Prospective Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Conventional Housing***. (Value estimate will be based upon a highest and best use analysis as-if not encumbered by USDA program provisions.)

SPECIAL NOTES AND INTENDED USE:

- All value conclusions cited in the appraisal must report and label the specific value as cited above in "Appraised Value To Request."
- The intended use of the appraised value *"Prospective Market Valu*e, *subject to restricted rents within 7 CFR Part 3560.752(b)(1)(i)"* for a new or subsequent loan is to assist the underwriter with calculating the security value for the basis of a loan or loan guarantee.
- The intended use of the appraised value *"Prospective Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Conventional Housing"* for a new or subsequent loan is for <u>reasonable analysis and comparison</u> as to how the USDA restrictions affect the property. It should not be used as the basis of a loan or loan guarantee.
- "Prospective value" estimates are premised on an extraordinary assumption which presumes as fact uncertain information. An appraiser should only use an extraordinary assumption when it is reasonable to believe that the unknown condition is true. A prospective value for new or rehab construction should be based on an estimated date that construction would be completed and occupancy stabilized.
- When the value is "Subject To Restricted Rents" the appraiser must consider the impact of USDA program participation and report the value of intangible assets (financing, tax credits, grants, etc.) individually and separately from the real estate. Since intangible assets are nonphysical assets and not real estate the appraiser should never add the value of the intangible assets to the value of the real estate. USDA will identify intangible assets to be evaluated and provide information relevant and necessary for the evaluation of the intangible assets.
- All hypothetical conditions and extraordinary assumptions must be labeled as such and must be clear and conspicuous to the reader of the report.

2: EXISTING LOAN

VALUE REQUIRED FOR:

- Transfer
- Loan assumption
- Loan write-down
- Subordination

APPRAISED VALUE TO REQUEST:

- ***Market Value, Subject To Restricted Rents within 7 CFR Part 3560.752(b)(1)(i).*** (Must consider any rent limits, rent subsidies, expense abatements, and restrictive-use conditions that will affect the property. All intangible assets must be evaluated individually and separately from real estate.)

SPECIAL NOTES AND INTENDED USE:

- All value conclusions cited in the appraisal must report and label the specific value as cited above in "Appraised Value To Request."
- The intended use of the appraised value *"Market Valu*e, *subject to restricted rents within 7 CFR Part 3560.752(b)(1)(i)"* for an existing loan is to assist the underwriter with calculating the security value to determine if the existing loan is adequately secured.
- When the value is "Subject To Restricted Rents" the appraiser must consider the impact of USDA program participation and report the value of intangible assets (financing, tax credits, grants, etc.) individually and separately from the real estate. Since intangible assets are nonphysical assets and not real estate the appraiser should never add the value of the intangible assets to the value of the real estate. USDA will identify intangible assets to be evaluated and provide information relevant and necessary for the evaluation of the intangible assets.
- The use of a hypothetical (false) condition is not allowed.
- The appraisal is to reflect the value of the property in its current physical condition.
- All hypothetical conditions and extraordinary assumptions must be labeled as such and must be clear and conspicuous to the reader of the report.

☐ **3: VALUE OF PROPERTY (Property does NOT qualify for Prepayment Incentives Offers within 7 CFR Part 3560.656 Incentives Offers).**

VALUE REQUIRED FOR:

- Validation of sale/marketing price
- Equity determination
- Acquisition of property into program

APPRAISED VALUE TO REQUEST:

- ***Market Value, within 7 CFR Part 3560.752(b)(1)(ii).*** *(*All existing restrictions and prohibitions must be considered including Restrictive- Use Provisions (RUP's).

SPECIAL NOTES AND INTENDED USE:

- All value conclusions cited in the appraisal must report and label the specific value as cited above in "Appraised Value To Request."
- The intended use of the appraised value *"Market Valu*e *within 7 CFR Part 3560.752(b)(1)(ii)"* is to determine the value of the property for sale/purchase and to determine the amount and availability of any equity.
- Equity is determined by the appraised value of the property less all loans and liens against it. It is not determined by a contract price or the individual wants or needs of a specific buyer or seller.
- An analysis of the highest and best use of the property using the four criteria including physically possible, legally permissible, financially feasible and maximally productive is required.
- The use of a hypothetical (false) condition is not allowed.
- The appraisal is to reflect the value of the property in its current physical condition.
- All hypothetical conditions and extraordinary assumptions must be labeled as such and must be clear and conspicuous to the reader of the report.

☐ **4: <u>VALUE OF PROPERTY</u> (Property qualifies for Prepayment Incentives Offers within 7 CFR Part 3560.656 Incentives Offers. There must be no prepayment prohibitions and RUP's must have expired.)**

VALUE REQUIRED FOR:

- Validation of sale/marketing price
- Equity determination

APPRAISED VALUE TO REQUEST:

- ***Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Unsubsidized Conventional Housing in compliance with 7 CFR Part 3560.656(c)(1)(i).***

SPECIAL NOTES AND INTENDED USE:

- All value conclusions cited in the appraisal must report and label the specific value as cited above in "Appraised Value To Request."
- The intended use of the appraised value *"Market Value within 7 CFR Part 3560.752(b)(1)(ii)**,** Premised Upon A Hypothetical Condition As-If Unsubsidized Conventional Housing in compliance with 7 CFR Part 3560.656(c)(1)(i)"* is to determine the value of the property that qualifies for an Incentive Offer within 7 CFR Part 3560.656 for sale/purchase and to determine the amount and availability of any equity.
- Equity is determined by the <u>appraised</u> value of the property less all loans and liens against it. It is not determined by a contract price or the individual wants or needs of a specific buyer or seller.
- Using the hypothetical condition "as unsubsidized conventional housing" according to 7 CFR Part 3560.656(c)(1)(i) means when the appraiser develops their Highest and Best Use analysis they will not recognize any Rural Development restrictions or subsidies and must only consider the property as continued use as housing (apartments, condos, elderly, labor housing, etc.). They must still consider all other legal restrictions or benefits that apply to the property. If the appraiser determines that subsidies from other sources provide the highest and best use of the property this hypothetical condition according to 7 CFR Part 3560.656 (c)(1)(i) does not restrict that use.
- The appraisal is to reflect the value of the property in its current physical condition.
- All hypothetical conditions and extraordinary assumptions must be labeled as such and must be clear and conspicuous to the reader of the report.

☐ **5: VALUE FOR SALE - ELIGIBLE AS PROGRAM PROPERTY**

VALUE REQUIRED FOR:

- Maintain in program, REO's, foreclosure, etc.

APPRAISED VALUE TO REQUEST:

- *Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Conventional Housing.* (Value estimate will be based upon a highest and best use analysis as-if not encumbered by USDA program provisions.)

AND:

- ***Market Value, Subject To Restricted Rents within 7 CFR Part 3560.752(b)(1)(i).*** (Must consider any rent limits, rent subsidies, expense abatements, and restrictive-use conditions that will affect the property. All intangible assets must be evaluated individually and separately from real estate.)

SPECIAL NOTES AND INTENDED USE:

- All value conclusions cited in the appraisal must report and label the specific value as cited above in "Appraised Value To Request."
- The intended use of the appraised value "*Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If Conventional Housing"* is to assist in the determination of an acceptable bid or sale price.
- The intended use of the appraised value *"Market Value, Subject To Restricted Rents within 7 CFR Part 3560.752(b)(1)(i)" is to* assist in the determination of an acceptable bid or sale price.
- Unless otherwise directed, all market value appraisals will provide an analysis of the highest and best use of the property using the four criteria including physically possible, legally permissible, financially feasible and maximally productive
- When the value is "Subject To Restricted Rents" the appraiser must consider the impact of program participation and report the value of intangible assets (financing, tax credits, grants, etc.) individually and separately from the real estate. Since intangible assets are nonphysical assets and not real estate the appraiser should never add the value of the intangible assets to the value of the real estate. USDA will identify intangible assets to be evaluated and provide information relevant and necessary for the evaluation of the intangible assets.
- The appraisal is to reflect the value of the property in its current physical condition.
- All hypothetical conditions and extraordinary assumptions must be labeled as such and must be clear and conspicuous to the reader of the report.

☐ **6: VALUE FOR SALE - NON PROGRAM PROPERTY**

VALUE REQUIRED FOR:

- Properties leaving program, REO's, etc.

APPRAISED VALUE TO REQUEST:

- *Market Value within 7 CFR Part 3560.752(b)(1)(ii), Premised Upon A Hypothetical Condition As-If A Conventional Market Property.* (Value estimate will be based upon a highest and best use analysis as-if not encumbered by USDA program provisions.)

  AND POSSIBLY:
- ***Liquidation Value Premised Upon A Marketing Period* of (*enter days*) *Days* (marketing period prescribed by USDA)**

SPECIAL NOTES AND INTENDED USE:

- All value conclusions cited in the appraisal must report and label the specific value as cited above in "Appraised Value To Request."
- The intended use of the appraised value "*Market Value Premised Upon A Hypothetical Condition As-If A Conventional Market Property" is to* assist in the determination of an acceptable bid or sale price
- Unless otherwise directed, all market value appraisals will provide an analysis of the highest and best use of the property using the four criteria including physically possible, legally permissible, financially feasible and maximally productive
- The intended use of the appraised value "*Liquidation Value Premised Upon a Marketing Period* of (*enter days*) *Days"* is to assist in the determination of an acceptable bid or sale price.
- Request for ***Liquidation value*** is applicable only if USDA is considering selling within a prescribed time frame which may or may not be the same as the traditional marketing period. USDA staff must determine whether Liquidation Value is required, and supply the appraiser with the prescribed marketing time to be associated with the property liquidation.
- USDA will provide a specific marketing period for a Liquidation Value. If the prescribed marketing period is less than the traditional marketing period as determined by the appraiser, the appraiser will analyze and estimate the value associated with the prescribed marketing period. A prescribed marketing period may result in a value estimate premised upon an extraordinary assumption.
- All hypothetical conditions and extraordinary assumptions must be labeled as such and must be clear and conspicuous to the reader of the report.

ATTACHMENT 7-D

STANDARD STATEMENT OF WORK (SOW) FOR MULTI-FAMILY HOUSING CONTRACT APPRAISALS

Background: USDA Rural Development provides loans to eligible applicants for multi- family housing properties. In support of this program, Rural Development requires the services of qualified persons or firms to provide appraisals of subsidized Multi-Family Housing properties. All appraisals must be in compliance with the current edition of the *Uniform Standards of Professional Appraisal Practice* (*USPAP*) and Rural Housing Service (RHS) Multi-Family Housing appraisal requirements (supplemental standards), which are set forth in the Statement of Work (SOW), *7 CFR 3560, subpart P*, and Chapter 7 of the *RHS HB-1-3560*. The appraiser should note that there are other agencies within Rural Development with different appraisal needs and requirements.

Professional Qualifications: All Agency Multi-Family Housing appraisals must be written by a State Certified General Appraiser, certified in the State in which the subject property is located. The appraiser must have the specialized knowledge and experience necessary to be competent to appraise subsidized housing. The appraiser must understand the housing programs, value types and definitions, real and intangible property rights, use restrictions, pertinent tax considerations, and methods for valuation of various types of favorable financing involved in the appraisal of subsidized housing.

Request for Quote (RFQ): The RFQ will be used to request proposals from appraisers via fax or e-mail and will contain basic property information, services requested, special requirements, and any additional information the appraiser will need to bid appropriately. It is the appraiser's responsibility to understand the scope of the assignment and its requirements. When the appraiser receives the RFQ, he/she is to notify the requesting representative by fax or e-mail within __ hours (1) that the appraiser is unavailable to bid on the assignment, or (2) with the amount of the fee and the number of calendar days required to complete the assignment.

Contract for Appraisal Services (CAS): Once the appraiser has been selected to complete the assignment, a Rural Development representative will provide a CAS by fax or e-mail. The CAS form will contain the same information as the RFQ but will also include Rural Development and property contacts as well as the agreed upon fee and due date. Rural Development will also inform the appraiser if he/she has not been awarded the assignment. The required number of copies of the appraisal may vary, and the appraiser must pay attention to the number specified on the CAS, as well as the specific delivery instructions. The CAS will specify to whom the reports are to be addressed and where the reports and invoice should be delivered.

Subcontracting: The appraiser engaged by Rural Development or a qualified employee or associate of the appraiser, must perform the appraisal and must not subcontract it, or any part of it, to another person without written consent of the Rural Development Contracting Officer.

Post Award Conference: The appraiser must contact the Contracting Officer's Representative (COR), identified in the CAS, to schedule a post-award telephone conference. The COR (usually the State Appraiser) will discuss appraisal requirements with the appraiser and answer questions about the assignment. Furthermore, the COR will be the appraiser's contact with the Agency during the course of the assignment. Again, it is the appraiser's responsibility to understand the scope of the appraisal and its requirements.

Client: The appraiser must understand and agree that USDA Rural Development is the appraiser's client, and all reports must be addressed to USDA Rural Development (and any other intended user specified by the Agency). Any questions related to the form or substance of the assignment will be directed to the COR and will not be directed to the property owner.

Property Contact: The appraiser should call the property contact, identified in the CAS, for gaining access to the property and in most cases for procuring property specific data relevant to the assignment. Appraisal fees or turnaround times should not be discussed with the property contact. The appraiser must notify the COR *immediately* if any of the following occurs: 1) the appraiser cannot gain adequate access to the property, 2) the appraiser does not receive essential property information in a timely manner, 3) the appraiser has previously appraised or is in the process of appraising the property, 4) the appraiser has any other potential conflict of interest with respect to the assignment.

Confidentiality: The appraiser must keep all information and materials furnished by Rural Development, the owner, and/or property contact regarding the subject property confidential, as required by USPAP and the Gramm-Leach-Bliley Act. The appraiser may use such information only in connection with performance of the assignment. The appraiser must agree to prevent the unauthorized disclosure, misuse, or alteration of the confidential information. Any information obtained through public sources is not considered confidential information. Disregard of this privacy requirement will be cause for immediate debarment as a contractor for the federal government.

Nondiscrimination: All appraisals of Section 515 Rural Rental Housing or Section 514/516 Farm Labor Housing properties must comply with the Fair Housing Amendments Act of 1988. According to the Act, it is unlawful for an appraiser to use factors that are discriminatory on the basis of race, color, religion, sex, disability, familial status, or national origin in the sale, rental, leasing, or financing of housing.

Assumptions, Hypothetical Conditions, and Limiting Conditions: All extraordinary assumptions, hypothetical conditions, and limiting conditions must be clearly described in a single location near the beginning of the report and in appropriate sections of the appraisal. In addition, extraordinary assumptions and hypothetical conditions must be restated wherever the appraiser opines to the final value(s). Extraordinary assumptions and hypothetical conditions also must be discussed with and agreed to by the COR prior to completion of the report. General assumptions and limiting conditions that reduce the normal scope of appraisal due diligence are not allowed.

Potential Environmental Hazards: The appraiser must note any suspected environmental hazards, including issues external to the property that could adversely impact the property's value. Examples of environmental hazards would include damaged asbestos-containing building materials, underground storage tanks, chemical leaks, spills, or staining of ground surfaces, or on-site waste disposal such as sludge, oil, paints, or chemical residues. If the appraiser observes any suspected environmental hazards, he/she must notify the COR immediately and refrain from finalizing aspects of the appraisal that could be impacted until resolution of the issue or until instructed otherwise.

Americans with Disabilities Act (ADA): Appraisers must be familiar with the general provisions of the ADA because subsidized housing is a property type that is likely to be affected. The appraiser must consider what impact (if any) noncompliance with the ADA has on the value of the subject property. Any impact on value must be supported by market evidence.

Appraisal Report Formats: The appraisal type (complete or limited), report type (self-contained, summary, or restricted use), and report format (narrative or form) will be set forth in Rural Development's authorizing Contract for Appraisal Services (CAS). Narrative formats are preferred for most Multi-Family Housing appraisals, with the level of detail dependent on the scope of work and the requested appraisal type and report type. Form reports completed on *Form RD 1922-7, Appraisal Report for Multi-Unit Housing, FNMA Form 1050, FHLMC Form 71A*, or the Uniform Commercial Industrial Appraisal Report (UCIAR) are generally acceptable, as long as they are modified to meet USPAP and Agency requirements and are agreed upon in advance.

Approaches to Value: The approaches to value (Cost Approach, Sales Comparison Approach, and Income Approach) that are to be included in the appraisal depend on the specific assignment and will be specified in the CAS. When the purpose of the appraisal is to conclude *market value*, all three approaches to value must be included as part of a Complete Appraisal. When the purpose of the appraisal is to conclude *market value, subject to restricted rents*, the Cost Approach and the Income Approach must be included, but the Sales Comparison Approach is typically not applicable and may be excluded. When the purpose of the appraisal is to conclude *value-in-use* of an on-farm labor housing project, only the Cost Approach is applicable, and the other two approaches are excluded. For some assignments, an approach to value that is typically applicable may not be applicable. When this is the case, the appraiser, upon receiving the RFQ, must discuss this issue with the COR so that the CAS will correctly specify the approaches to value that will be included in the report. If, during the course of the assignment, the appraiser determines that an approach is not applicable, he/she must obtain the approval of the COR to exclude the approach from the report, and the CAS must be modified.

Value Types: The types of value (e.g., *market value* or *market value, subject to restricted rents* or *insurable value*) to be reported, including values of various types of favorable financing, will be specified in the CAS.

Complete Appraisal Requirements: All RHS Complete Appraisals must comply with the following unless the CAS requires otherwise:

1) All appraisal reports must comply with the current edition of *USPAP*. Specifically, all reports must include the following items required by Standards 1 and 2 of *USPAP*:
   - Identification of the appraisal type and report type,

- Identification of the client and any other intended users of the appraisal,
- Identification of the intended use of the appraisal,
- Description of the subject real estate,
- Identification of the real property interest (property rights) appraised,
- Identification of the purpose of the appraisal,
- Identification and definition(s) of the value type(s) reported,
- Identification of the effective date(s) of the appraisal and the date of the report,
- Description of the scope of work used to develop the appraisal,
- Disclosure of all assumptions, hypothetical conditions, and limiting conditions that directly affect the appraisal,
- Description of the information analyzed, the appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions,
- Description of the use of the real estate existing as of the date of value and the use of the real estate reflected in the appraisal; and (for market value) an analysis of the highest and best use of the real estate,
- Disclosure of any permitted departures from specific requirements of Standard 1 of *USPAP* and the reason for excluding any of the usual valuation approaches,
- A signed certification in accordance with *USPAP* Standards Rule 2-3.

2) All reports must include an executive summary.
3) All reports must include a legal description of the subject property.
4) All reports must include photographs of the interior and exterior of the subject property and of the exterior of all rent comparables and sales comparables.
5) All reports must include the following maps, showing the location of the subject:
    - Regional map
    - City map
    - Flood plain map
    - Land Sales map
    - Sales Comparables map
    - Rent Comparables map
6) All reports must include the following exhibits of the subject property:
    - Survey
    - Site plan
    - Floor plans
7) All analyses within the Income Approach must be well supported. When the assignment is to conclude *market value, subject to restricted rents*, the subject's 3-year operating history should typically be used as the primary data source to project the subject's other income, vacancy, and operating expenses. A set of expense comparables should be compiled from recent operating statements for similar restricted properties within the subject's housing program. This data can be obtained from Rural Development and used to support these projections. All expense analyses must include a tabulated set of expense comparables and should also include supporting information from an expense survey done by RHS or a State or local housing authority, if available. The capitalization rate selected for the subject must be derived from the most recent sales of similar properties in the local (or nearest similar) conventional apartment market. Support for this overall rate should be provided using other accepted methods such as the band-of-investment technique, the debt coverage ratio formula,

and regional investment criteria surveys. If the pro forma income, vacancy, expenses, or capitalization rate is not adequately supported, the Rural Development Review Appraiser will require the contract appraiser to make revisions that provide the necessary support before the appraisal can be accepted.

8) Any method that includes the use of note rate rent as Potential Gross Income (PGI) in the Income Approach pro forma to derive a value equal to the sum of the *market value, subject to restricted rents,* plus the value of the interest credit subsidy is not acceptable appraisal practice. Appraisers must not use this procedure in Agency Multi-Family Housing appraisals.
9) All reports must conclude the market rents for the subject's units. A market rent adjustment grid showing quantitative adjustments in specific percentages or dollar amounts must be included and be well supported. When the assignment is to conclude *market value, subject to restricted rents*, the report must state whether the base rate (restricted) rents are less than, equal to, or higher than market rents. Market rents must be estimated to determine if the subject's base rate rents are attainable without RA. Base rate rents must not be higher than market rents, unless an exception is made, according to the policy of Conventional Rents for Comparable Units (CRCU).
10) All reports must include an estimate of the remaining economic life of the subject.
11) All appraisals of existing properties must include a discussion of deferred maintenance at the subject property. Items of deferred maintenance must be listed, and the cost to cure each item must be estimated, with support provided. The final value must be calculated by subtracting the total cost estimated to cure all deferred maintenance from the value indicated as if no deferred maintenance existed.
12) When favorable financing is involved, the appraisal report must contain a narrative identifying each source of financing. The amount and terms of each type of favorable financing must be described, and each type of favorable financing must be valued separately from the *market value, subject to restricted rents,* of the property. Valuation of “interest credit subsidy” from Section 514/515 loans should be consistent with Attachment 7-H.
13) When the assignment is to conclude *market value, subject to restricted rents*, the subject's operating statements for the preceding three full years and the proposed budget for the current year must be used in the expense analysis and included in the addenda of the report, if available.
14) Appraisals of properties with proposed rehabilitation must include *Form RD 1924-13*, *Estimate and Certificate of Actual Cost*, in the addenda.
15) A copy of the CAS must be included in the addenda of the appraisal report.

Review of Appraisal: Appraisal reports are subject to review by Rural Development. Appraisers must be prepared to discuss their analyses, opinions, and conclusions and provide additional written support, clarification, and/or corrected appraisal pages if requested.

Accountability: The engaged appraiser must inspect the subject property and be prepared to discuss the appraisal report. A staff appraiser or associate may participate in the appraisal assignment but must either sign the report or be identified, by name, as having provided significant professional assistance in the appraiser's certification. If a staff appraiser or associate wrote the majority of the report, that staff appraiser or associate may be present during any discussion of the assignment. However, it is the engaged contract appraiser whose work product has been identified as acceptable by Rural Development, and that appraiser must sign the report and be accountable for it.

Defense of Appraisal: The Agency may require the appraiser to defend the appraisal in court or in Rural Development's appeals process. This would constitute a consulting assignment that would be contracted separately from the original appraisal assignment.

Payment of Services: Late delivery of any report may result in liquidated damages. Lacking specific arrangements in writing to the contrary, Rural Development may impose a penalty equal to the lesser of 5% of the appraisal fee per day, or $100 per day, for each calendar day beyond the scheduled due date. The late fee penalty is based on the calendar days between the due date and the date the appraisal report is received by Rural Development. If delivery of the report is 30 days past due, the appraisal engagement is cancelable by Rural Development, and the appraiser's right to all fees associated with the assignment may be forfeited.

ATTACHMENT 7-E

APPRAISAL INFORMATION SHEET (EXAMPLE), ATTACHMENT TO SOW

Appraisal Type: (Complete / Limited)
Report Type: (Self-Contained / Summary / Restricted Use)
Appraisal Format: (Narrative / Form)
Client: Ann Smith, Oregon State Appraiser, USDA Rural Development
USDA Rural Development Contact: Ann Smith, Oregon State Appraiser and Contracting Officer's Representative (COR); Phone: 503-414-3300
Property Contact: Sue Jones, on-site manager; Phone: 503-679-3857
Intended Users of Appraisal: Oregon Housing and Community Services (OHCS); Bedford Falls Limited Partnership (owner)
Intended Use of Appraisal: To fulfill loan underwriting requirements for permanent financing of the subject property
Purpose of Appraisal: To submit supported opinions of the required value(s), in conformity with *USPAP* and the appraisal policy of USDA Rural Housing Service
Property Type: USDA Rural Development Section 514/516 Off-Farm Labor Housing complex
Property Status: (Existing / Proposed)
Property Interest Appraised: fee simple estate, as restricted, subject to short-term leases
Property Owner: Bedford Falls Limited Partnership
Property Name: Bedford Falls Apartments
Property Address: 1945 Maple Avenue, Bedford Falls, OR 97055
Property Description: (number and type of buildings, number of stories, number and type of units, NRA, GBA, year of construction, site size, amenities, parking, etc.) The subject property is a proposed 30-unit USDA Rural Development Section 514/516 Off-Farm Labor Housing complex, situated on a 2.50-acre site. It will have a NRA of 28,602 SF and a GBA of 32,656 SF. There will be five 2- and 3-story buildings with cementicious siding exteriors and pitched asphalt shingle roofs. 1-, 2-, and 3-BR units, ranging from 643 SF to 1,311 SF, will be offered. There will be a 4,054 SF community building containing offices, kitchens, and laundry facilities, as well as paved parking with 64 open spaces (2 handicapped spaces). Completion of construction is scheduled for April 30, 2005.
Project Financing: Financing for the project will come from four sources, as follows:

- USDA Rural Development will make a Section 514 loan for $1,300,000. The loan term is 33 years, and the loan is amortized over that period. The effective rate of interest is one percent. The borrower's monthly payment is $3,855.59.
- USDA Rural Development will make a Section 516 grant for $1,500,000.
- The Clackamas County Community Development Division has awarded a HOME Grant in the amount of $500,000.
- OHCS has awarded tax credits in the amount of $950,000. (See the borrower's Syndication Proposal Agreement for terms.)

Value Types Required: The following values are required:

- Prospective market value, subject to restricted rents, of the fee simple estate, as restricted, subject to short-term leases, of Bedford Falls Apartments, as of completion of construction, April 30, 2005
- Value of interest credit subsidy from the USDA Rural Development Section 514 loan
- Value of the USDA Rural Development Section 516 grant
- Value of the Clackamas County Community Development Division HOME grant
- Value of the OHCS tax credits
- Insurable value

Approaches to Value: The Cost Approach and the Income Approach must be included in the appraisal. The Sales Comparison Approach is not applicable and is not required.

Rental Assistance: (existing number of units/proposed number of units) The subject property will have 30 units of Rental Assistance (RA).

Utilities: Tenants pay for: ___ Electricity ___ Gas ___ Water/Sewer

Assumptions, hypothetical conditions, and limiting conditions: The *prospective market value, subject to restricted rents*, should be based on the *specific assumption* that the subject property retains its 30 units of Rental Assistance (RA). It should also be based on a *limiting condition* citing the market conditions from which the prospective value opinion was made.

Number of Copies: 3

Mail Reports to:

Ann Smith (2 copies)
State Appraiser
USDA Rural Development
101 SW Main St., Suite 1410
Portland, OR 97204-3222

James Miller (1 copy)
Director
Oregon Housing & Community Services
725 Summer St., NE
Salem, OR 97309

ATTACHMENT 7-F

APPRAISAL DATA PACKAGE CHECKLIST

___ sales contract or purchase agreement
___ legal description
___ Rural Development Mortgage or Deed of Trust
___ Housing Assistance Payment (HAP) contract (if applicable)
___ description of restrictive use provisions
___ environmental report
___ lead-based paint inspection report
___ Rural Development unit-by-unit inspection
___ market study
___ prior appraisal
___ survey
___ site plan
___ floor plans
___ unit mix (number of units by type, size, rent)
___ recent rent roll
___ tenants waiting list
___ operating statements for subject property from previous 3 years
___ operating statements for five expense comparables from last full year (property name, address, age, number of units, and expense year included)
___ proposed budget for current year
___ plans, specs, and cost estimates (new construction)
___ Form RD 1924-13, *Estimate and Certification of Actual Cost* (rehabilitation)
___ Sources & Uses Comprehensive Evaluation (SAUCE Report)
___ ownership history for past three years
___ financing information (list of existing and proposed financing sources with detailed descriptions of terms for each; e.g., amount of financing, loan balance, interest rate, loan term, remaining loan term, amortization period, payment)

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ATTACHMENT 7-G

SAMPLE TRANSMITTAL LETTER

_______________, 20__
______________________ Appraisal Services
______________________ Member of Appraisal Institute (MAI)
____
_____________, (State) _____

Dear _______________________:

In our recent telephone conversation you quoted a price of $__________ to complete one (1) Multi-Family Appraisal for the following Multi-Family Housing property: __________________ ____ (Address, City and State, County).

The completed appraisal shall provide __________ estimate of value. The appraisal shall determine the _______________ value of the project as ______________ housing.

Rural Development is issuing Purchase Order (60-0496-0-C00xx) [sample number] to your firm. You will have until _________________ (date) to complete and return 3 copies of the appraisal to _________________________, Contracting Officer's Representative (COR), Rural Development, ________________________________ _____________ (Address, City and State). The Government is allowed fifteen (15) days from the date of receipt of the submitted appraisal for the appraisal review. The invoice shall be submitted to the COR's attention at the same address. Upon acceptance of the appraisal and receipt of a properly prepared invoice payment shall be processed in accordance with the Prompt Payment Act.

We are enclosing the *AD-838, Purchase Order*; *Form RD 2024-18, Designation of Contracting Officer's Representative (COR)*; and the Appraisal Contract Terms and Conditions which includes the statement of work, clauses and other information.

Please note that this written correspondence confirms our oral discussions and establishes the completion dates for the performance of the Contract.

Thank you for your prompt attention. If you have questions please contact me at __________ (phone number).

Sincerely,

____

Contracting Officer
Enclosures
cc: COR/MFH Program Director, _____________ State Office, ________________
MFH Housing Specialist, ____________________ AO, ____

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ATTACHMENT 7-H

GUIDE FOR VALUATION OF INTEREST CREDIT SUBSIDY

Interest Credit Subsidy

Interest credit is a form of federal assistance available to eligible borrowers that reduces the effective interest rate of a loan. The USDA Rural Housing Service (RHS) offers direct loans with very favorable terms for affordable housing in the Rural Rental Housing Program (Section 515) and the Farm Labor Housing Program (Section 514). Section 514 and 515 permanent loans for new construction and subsequent loans for rehabilitation include interest rates as low as 1 percent. These loans are made at a “note rate” of interest, but a “basic rate” of interest to the borrower is typically 1 percent. A monthly mortgage payment is calculated at the note rate of interest, and the loan is amortized at the note rate of interest, but the borrower's actual mortgage payment is based on the basic rate of 1 percent. The difference between the note rate payment and the basic rate payment is the *interest credit*. The borrower is effectively subsidized with an income stream represented by the monthly *interest credit* that is available for the term of the loan.

In appraisals of Section 514 and Section 515 Multi-Family Housing properties, valuation of the *interest credit subsidy* (favorable financing) is part of the assignment when the *market value, subject to restricted rents*, must be concluded. When *interest credit subsidy* is the only favorable financing involved, the security value, on which the loan is based, has two components: 1) the *market value, subject to restricted rents*, of the real estate, and 2) the value of the *interest credit subsidy*. The present value (PV) of the *interest credit subsidy* can be calculated with a financial calculator using a simple discounted cash flow if three variables are known: payment (PMT), discount rate (i), and period (n). Determination of each of these three variables is discussed below.

Methodology for Valuation of Interest Credit Subsidy

The first variable to consider, which is input as payment (PMT) in a financial calculator, is the income stream that accrues to the borrower from the savings in mortgage payments resulting from the *interest credit*. With the RHS direct loan, the borrower typically will make 360 monthly mortgage payments based on an interest rate of 1percent. Without the RHS direct loan, the borrower would have to obtain alternative conventional financing at a significantly higher market interest rate, resulting in higher monthly mortgage payments. Therefore, the borrower's income stream is equal to the difference between the monthly mortgage payment that would have been required at the conventional rate of interest and the actual mortgage payment at the reduced rate. (It should be noted that the USDA note rate of interest cannot be used to calculate the higher conventional payment because this rate does not represent a mortgage interest rate available to the borrower at the time of the appraisal.)

The second variable used in the calculation is the discount rate (i). The discount rate to be applied to the income stream is simply the alternative conventional mortgage interest rate. This is the rate of interest at which the borrower would have had to pay if a conventional loan had been obtained, so this is the rate at which the borrower saves with the favorable financing. The conventional mortgage interest rate is extracted from the subject's lending market.

The third variable to determine is the period (n) over which the income stream is to be discounted. The loan term, or remaining loan term, is known at the time of the appraisal. Although the borrower might hold the property for a holding period less than the loan term, the income stream from the favorable loan is available for the period of the loan. The *interest credit subsidy* should be valued according to the actual terms of the loan, so the appraiser should discount the income stream over the term of the loan. For new construction, the loan term is 30 years for a Section 515 loan and 33 years for a Section 514 loan. The appraiser should use these terms for the period of the loan. For an existing property, the remaining loan term, which should not exceed the estimated remaining economic life of the property, should be used for the period of the loan.

The value of the *interest credit subsidy* from RHS direct loans on most existing properties can be calculated by subtracting the monthly debt service at the below-market rate of interest from the monthly payment at the current rate offered for conventional loans and discounting the difference by the current conventional interest rate over the remaining loan term. For RHS direct loans on proposed new construction, an additional step is required if the amortization period is longer than the loan term. With conventional financing, a loan with a term of 30 years is amortized at the end of the 30-year term. However, with a RHS direct loan that has a loan term of 30 years and an amortization period of 50 years, a large balloon payment is due at the end of 30 years. The PV of the balance of the RHS direct loan at the end of the 30-year loan term (the PV of the balloon payment) must be subtracted from the present value of the 30-year income stream to derive the value of the *interest credit subsidy*.

Example Problem and Solution

The following example problem is used to illustrate the method for valuing the *interest credit subsidy*.

Problem:

A Section 515 direct loan of $1,000,000 is offered by USDA Rural Development with a term of 30 years and an amortization period of 50 years. The loan is to be amortized at the USDA note rate of interest of 6.0%, but the base rate of interest to the borrower is 1.0%. At the end of the 30-year loan term, a balloon payment is due. Alternative conventional financing includes a 30-year loan term, completely amortized after 30 years, and an interest rate of 7.0%. What is the value of the "interest credit subsidy" or below-market financing?

Solution:

The loan amount in the example problem is $1,000,000. With conventional financing, the monthly payment at 7.0% interest, amortized over 30 years, would have been $6,653.02. This payment can be calculated on an HP-12C calculator using the following keystrokes:

1,000,000 PV
7.0 g i
30 g n
Solve for PMT = -6,653.02

With the Section 515 direct loan and *interest credit*, the monthly payment, at 1.0% interest, amortized over 50 years, is $2,118.59 (calculated in the same way), but a balloon payment of $734,760 is due at the end of 30 years. The borrower makes a monthly payment based on a 1.0% interest rate. However, the loan is amortized at the note rate of interest at the time of the loan (6.0% in this example), as if the mortgage payment was the sum of the borrower's payment and the *interest credit* calculated by USDA. The balloon due at the end of 30 years on the RHS loan can be calculated on an HP-12C calculator using the following keystrokes:

1,000,000 PV
6.0 g i
50 g n
Solve for PMT = -5,264.05
30 g n
Solve for FV = -734,760

The difference in the payments at the two different interest rates is $4,534.43 ($6,653.02 - $2,118.59) per month. The borrower saves $4,534.43 per month due to the below-market financing. Without the benefit of the favorable financing (*interest credit subsidy*), the owner would pay an additional $4,534.43 per month, at an interest rate of 7.0%, over the projected holding period. The projected holding period for the subject property is the loan term, 30 years.

With the Section 515 direct loan, a large balloon payment is due at the end of the 30-year loan term, but a conventional loan would be fully amortized at the end of the 30-year loan term, and there would be no balloon. Therefore, to calculate the value of the *interest credit subsidy*, the present value (PV) of the balance of the RHS loan at the end of the 30-year loan term (the PV of the balloon payment) must be subtracted from the present value of the income stream resulting from the savings in the mortgage payments. The present value of the balloon payment is calculated by discounting the balloon payment ($734,760) by the current mortgage interest rate (7.0%) over the term of the loan (30 years). In this example, the PV of the balloon payment can be calculated with an HP-12C calculator using the following keystrokes:

734,760 CHS FV
7.0 g i
30 g n
Solve for PV = 90,527

The value of the *interest credit subsidy* is equal to the amount of the monthly debt service saved, discounted by the current conventional mortgage interest rate over the remaining loan term, minus the present value of the RHS direct or guaranteed loan balloon payment. The value of the *interest credit subsidy* for the subject property can be calculated with an HP-12C calculator using the following keystrokes:

4,534.43 CHS PMT
7.0 g i
30 g n
Solve for PV = 681,559
90,527 –
Value of interest credit subsidy = $591,032
The Value of the Interest Credit Subsidy is $591,000 (rounded)

Conclusion

When appraising existing properties, calculation of the value of the *interest credit subsidy* usually does not involve a balloon payment. Only valuation of the income stream is considered. The appraiser should obtain the current balance of the original loan from the Rural Development Office. The remaining loan balance and the remaining term of the loan are used to calculate the monthly mortgage payment at the current conventional interest rate. The appraiser should use the borrower's actual payment based on a below-market rate (usually one percent) that has been calculated by the Rural Development Office in this process. The difference in the payments at the two rates is then discounted at the current conventional mortgage interest rate over the remaining loan term to calculate the value of the *interest credit subsidy*.

The *interest credit subsidy* for a RHS original loan should be valued separately from the *interest credit subsidy* of any subsequent RHS loans. *Interest credit subsidy* should be valued separately from the *market value, subject to restricted rents*, of the real property.

ATTACHMENT 7-I

USDA Rural Development				
Insurable Value Calculation				
Property Name:				
Street Address:				
City, County, State, Zip:				
BASE COST			$0.00	PSF
Main Structure			$0.00	
Sprinkler			$0.00	
Other			$0.00	
Adjustments and/or Multipliers			0	
TOTAL BASE COST PER SQ. FT			$0.00	
Building Area Square Footage			0	SF
TOTAL REPLACEMENT COST NEW			$0.00	
EXCLUSIONS	Per SF	Percent		
Excavations	$1.00	0.00%	$0	
Foundations	$1.00	0.00%	$0	
Site Work	$1.00	0.00%	$0	
Site Improvements	$0.00	0.00%	$0	
Architect's Fees	$0.00	0.00%	$0	
Underground Piping	$0.00	0.00%	$0	
TOTAL EXCLUSIONS			$0	
INCLUSIONS				
Appliance Packages			$0	
Patios / Balconies, etc.			$0	
TOTAL INCLUSIONS			$0	
CONCLUDED INSURABLE VALUE				
Total Replacement Cost New			$0	
Less Total Exclusions			$0	
Plus Total Inclusions			$0	
CONCLUDED INSURABLE VALUE			$0	

ATTACHMENT 7-J

COVER LETTER FOR RELEASED APPRAISAL

(*date*)

USDA Rural Development

(*State Office address*)

(*inside address*)

Re: Real Property Appraisal of (*name and address of property*)

Dear Sir or Madam:

Enclosed is a copy of the appraisal report on the above referenced property that you requested. You may contact the Rural Development State Appraiser, (*name; e-mail address; phone number*), to discuss any errors or deficiencies that you identify in your review of the appraisal. The Rural Development State Appraiser, who will also have reviewed the appraisal, will decide whether any of the errors or deficiencies that you have identified are material to value and if revisions by the appraiser or modifications by the reviewer can or should be made. The Rural Development State Appraiser will make one of four possible dispositions of the appraisal: (1) the appraisal is accepted; (2) the appraisal is accepted as revised by the appraiser; (3) the appraisal is accepted as modified by the reviewer; or (4) the appraisal is rejected. Although the disposition concluded in the appraisal review report may be provided to the applicant/owner, the review report itself is intended for the internal use of the Agency and will not be released.

Sincerely,

(*name*)

(*title*)