CHAPTER 3: LENDER UNDERWRITING

3.1 INTRODUCTION

Key Topics in this Chapter

- Lender Responsibilities
- Lender's Underwriting Conclusions
- Borrower Eligibility Requirements
- Property Requirements
- Financing Terms and Lender Commitment
- Determining Property Value

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

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

SECTION 1: LENDER UNDERWRITING RESPONSIBILITIES

3.2 OVERVIEW

Prior to requesting a loan guarantee, the lender must underwrite and approve the loan. The underwriting analysis is a detailed evaluation of key elements of borrower experience and creditworthiness, market conditions, the value of improvements, and the ability of the property to attract the rents needed to generate sufficient cash flow to support the loan's debt service. The lender underwriting must identify and evaluate all the factors that could affect loan performance. Such factors must be reflected in the underwriter's conclusions detailed in the lender's narrative. The lender will underwrite the GRRHP guaranteed loan as prudently as any other loan in their portfolio.

3.3 SUMMARY OF LENDER RESPONSIBILITIES

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

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

SECTION 2: LENDER NARRATIVE

3.4 NARRATIVE REQUIREMENTS

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

Outline of Lender's Narrative

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

- A summary of the loan guarantee request, including under which option the loan is being guaranteed, the amount of the loan, guaranteed portion, and any subordinate financing;

- Conclusions about the borrower, including eligibility, financial capacity, and management review;

- Property history and loan purpose, including prior ownership and any outstanding financing;

- Conclusions about the property, including site and neighborhood analysis;

- A summary of any needed or planned improvements or physical needs.

- A summary of known or potential environmental concerns; and

- A determination of the project's value, including market analysis, appraisal, income and expense analysis, and valuation.

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

SECTION 3: BORROWER ELIGIBILITY

3.5 OVERVIEW

The borrower's intentions, qualifications, and capabilities are crucial to maintaining housing that is decent, affordable, and financially sound. Lenders must determine that the borrower is an eligible borrower for the Guaranteed Rural Rental Housing Program. Lenders must determine that the borrower is financially and legally capable of meeting all program requirements and has a good record of compliance with Agency and other Federal program requirements and financial obligations. In reviewing borrower eligibility, the lender must examine the background and capabilities of all of the principals of the ownership group.

3.6 ELIGIBLE BORROWERS

Eligible borrowers include individuals, corporations, state or local public agencies or an instrumentality thereof, partnerships, limited liability companies, trusts, Indian tribes, or any organization deemed eligible by the Agency.

To be considered eligible, the borrower must:

- Be a creditworthy entity. Borrowers who own any other business or engage in other business activities are eligible to participate in the program. However, the borrower must operate as a single asset entity, unless otherwise approved by the Agency.

Be able to maintain and operate rental housing in accordance with program objectives and requirements.

- Be in compliance with all legal and regulatory requirements with respect to any Agency program and any other Federal debt.

- Be a U.S. citizen(s) or permanent legal resident(s), a U.S. owned corporation, a limited liability company, or a partnership in which the principals are U.S. citizens or permanent legal residents.

The lender can establish the citizenship or permanent legal residency of a borrower by examining a birth certificate, passport or by any other method. If the borrower is not a U.S. citizen, the borrower must provide acceptable evidence of eligible status as a permanent legal resident, as listed in Exhibit 3-1.

3.7 INELIGIBLE BORROWERS

Borrowers are not eligible to receive Agency loan guarantees if:

- The borrowing entity or any one of its principals has been debarred by the Agency from future participation in any federal credit program; or

- The borrowing entity or any one of its principals has defaulted on any Federal debt.

- The borrowing entity or any of its principals has a relationship with the lender that violates the GRHHP's Lender's Agreement. . In cases where there is an established relationship, there must be a separation of duties.

The Agency will verify that the borrower does not appear on the debarment/suspension list by reviewing the "The System for Award Management" available on the Internet at and filing a copy of the print out of the Sam Search Results page in the application file. The Agency will also verify that the borrower does not appear on the Credit Alert Verification Reporting System (CAIVRS) or any other list the agency uses from time to time to determine borrower eligibility. The Agency should check SAM and CAIVRS at the initial application stage and prior to closing of the GRRHP loan. SAM and CAIVRS may be accessed through Treasury's Do Not Pay portal at http://donotpay.treas.gov/portal.htm.

The lender will provide evidence that the borrower does not appear on the debarment and suspension list in SAM list and the Credit Alert Verification Reporting System (CAIVRS) or any other list the agency requires to be used from time to time to determine borrower eligibility. As evidence, the Agency will accept a copy of the printout of the SAM search results page. This printout should be submitted with the project application package. The printed pages will serve as confirmation that the Do Not Pay (DNP) was checked by the lender. Lenders may access SAM and CAIVRS through Treasury's DNP portal at http://donotpay.treas.gov/portal.html.

The Agency will update the appropriate EPLS and CAIVRS fields in GLS with the information that the lender provides to the Agency.

3.8 BORROWER TYPES

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

Exhibit 3-1

Acceptable Evidence of Permanent Legal Residency

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

A. General or Limited Partnerships

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

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

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

B. Corporations

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

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

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

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

C. Limited Liability Companies (LLC)

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

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

D. Trusts

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

E. Public Agencies

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

F. Indian Tribes

Indian tribes are legal entities recognized by the Federal government as representing the legal interests of tribal members. Indian tribes must provide evidence of legal status in the form of a certificate or other official document of recognition from the Interior Department or other authorized agency of the Federal government. Only those entities that meet the definition of "Indian tribe" as provided in the Glossary are considered eligible.

G. Individuals

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

3.9 CERTIFICATION OF LEGAL ELIGIBILITY

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

3.10 BORROWER EXPERIENCE AND CAPACITY

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

Areas to be reviewed by the lender:

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

The lender must be able to verify that:

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

A. Construction and Rehabilitation Experience

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

- The developer is the owner or borrower entity and the party with ultimate responsibility for getting the project completed. The developer coordinates or directs an agent to coordinate the work of other members of the development team. To demonstrate qualifications, the developer must provide a narrative description of its organization, including its history, approximate annual operating budget, staff size, resumes of key staff members, and if applicable, information about the board of directors. This narrative should also include a factual description of the developer's experience in residential real estate activities (i.e., the number and type of projects and units built, total square footage, the total cost of the projects and source of financing, and pending litigation or mechanic's lien claims or contingent liabilities).

- The architect is responsible for the design of the project and for monitoring construction to ensure that it meets Agency requirements. The architect must provide a narrative about his/her firm that includes the history of the firm, professional staff, annual revenue, and experience designing similar projects.

- The contractor is responsible for construction of the project. The contractor must provide a narrative about his/her construction company including the history of the company, annual revenue, and track record in building projects of this type and size and pending litigation or mechanic's lien claims or contingent liabilities.

B. Property Management Experience

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

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

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

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

C. Financial Capacity

The borrower and its principals must be financially stable and have sufficient resources to develop and operate the property. Credit reports will assist in determining the financial stability of the borrower and will be ordered for the borrower as well as any person having a financial interest greater than .001 percent in the property. If the organization is newly formed and has not established any records of its activities as an organization, credit reports will be ordered on the principal members, stockholders and/or partners who hold at least a .001 percent interest in the property. Individual credit reports may subsequently be requested on these persons. If an organization has substantial interest in another organization, (i.e. tax credit investors) a credit report for such other organization may be obtained in the same manner as for the borrower. The borrower must demonstrate the financial resources to meet the specific requirements of the transaction.

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

The borrower must meet the following equity and reserve requirements.

- **Equity Requirement**. In the case of a for-profit entity, the borrower must commit equity capital in an amount equal to at least 10 percent of the total development cost. In general, total development cost includes the cost of constructing, purchasing, improving, altering, or repairing new or existing housing and related facilities and purchasing and improving the necessary land. Other items may be approved on a case-by-case basis by the Agency. In the case of a non-profit entity, the borrower must have equity capital in the amount of at least 3 percent of the total development cost. In either case, a deferred developer's fee cannot be used to fulfill the equity requirement. Equity must be in place prior to closing the construction loan note guarantee or the permanent loan note guarantee. Equity will be in the form of cash or value in the land being developed. On a case by case basis, the Agency at its sole discretion may consider and approve alternative financial instruments to meet equity requirements.

- **Program Reserve Requirements.** In addition to equity capital, the borrower must commit working capital to meet the program requirements for these reserves: an Operating and Maintenance Reserve (O&M Reserve), a Contingency Reserve during construction, an initial deposit to the Replacement Reserve, and an Interest Credit Reserve (if applicable) to be established prior to closing or conversion to permanent depending on the Option. None of these reserve requirements are mortgageable costs. The establishment of the reserves will not be waived.

◊ **O&M Reserve**

The O&M reserve is applicable under Guarantee Options One (permanent financing only guarantee), Two (construction advances and permanent financing guarantee), and Three (continuous guarantee). The O&M reserve will be at least two percent of the loan amount. The Agency may request additional O&M reserves if rent-up assumptions indicate the need for more reserves. The sources of the O&M reserve must be shown in the construction budget with a schedule of when the funds will be disbursed in the case of a construction loan note guarantee or will be funded prior to the closing of the permanent loan in the case of a permanent loan note guarantee. Funds contributed as O&M reserve funds will be contributed from the borrower's own resources and are not to be included as part of the total development cost (TDC) calculation. If Low-Income Housing Tax Credit (LIHTC) funds are being used to fund the Agency required O&M reserves, the TDC calculation must be reduced by the amount that is used to fund the O&M reserve.

Under guarantee Options One (permanent financing only guarantee) and Two (construction advances and permanent financing guarantee), funds for the O&M reserve may be contributed to the project upon the closing of a permanent loan. Under Option Three (continuous guarantee), the O&M reserve will be set up and fully funded prior to or at the closing of the construction loan. The funds will be deposited to the project's general operating account and lose their identity as O&M funds. The funds will not be returned except as a "surplus cash distribution" at the end of the year and only if the requirements of Paragraph 7.7 E. have been met.

The items that are typically funded by the original O&M reserve amount include, but are not limited to, property and liability insurance premiums, fidelity bond premiums when the borrower is also the property management organization, utility installation charges and deposits, maintenance equipment, lease forms, loan payments that may become due during construction, purchase of office equipment and furniture, community room furnishing, other movable equipment and furnishing, congregate items, advertising expenses, management fees, etc. Agency staff should verify that the initial payment for O&M reserves has been made in accordance with the Reserve Account Agreement or any other mortgage document governing O&M reserve accounts.

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

◊ **Lease-Up Reserve**

GRRHP offers the option of establishing a lease-up reserve in lieu of the 90% occupancy for 90 continuous days within the 120-day period immediately preceding the issuance of the permanent guarantee. The Conditional Commitment must state the permanent guarantee will not go into effect until **EITHER** the lender provides RHS staff with copies of rent rolls showing occupancy levels at 90 percent for 90 consecutive days (90/90 test) or the lender fully funds a lease-up reserve using the calculation below. Once one of these occur, the Agency will issue the lender written confirmation of the effective date of the guarantee on the permanent loan.

If the lender opts to set up the lease-up reserve (in lieu of 90% occupancy for 90 continuous days), it must be established as follows:

(1) For Options 1 and 2 - the funding schedule for the lease-up reserve must be included in the Agency-approved construction budget and be fully funded before the issuance of the permanent guarantee.
(2) For Option 3 - the lease-up reserve must be funded 30 days before the first Certificate of Occupancy is anticipated.

The lease-up reserve must be equal to or greater than an amount established by the Agency in a written notice. To calculate the required lease-up reserve amount, add the monthly amount of the Operations and Maintenance expense, the monthly amount of the Debt Service, and the monthly amount of the Reserve Deposit, then multiply this sum by three.

Lease-up Reserve Formula:
(Monthly O&M Expense + Monthly Debt Service Amount + Monthly Reserve Deposit) x 3 = Minimum Required 538 Lease-Up Reserve Amount.

This cash contribution is an additional amount, over and above the required initial O&M reserve contribution. Loan proceeds, project funds or a borrower contribution may be used to establish the lease-up reserve account.

If a lease-up reserve is established, the lease-up reserve funds may be released after six months of sustainable occupancy. Sustainable occupancy is when the approved underwritten occupancy rate is sustained for six consecutive months. The lender must request and receive Agency approval prior to releasing the funds. The lender must provide evidence (i.e. certified rent rolls or certification from the borrower), that the project has obtained sustainable occupancy. If loan proceeds or project funds were used to establish the lease-up reserve account, the funds must be deposited into the project's reserve account upon release. If an owner contribution was used to establish the lease-up reserve account, the funds may be released to the borrower.

◊ **Contingency Reserve**

When the Agency is guaranteeing the construction draws [as well as the permanent loan], the Agency requires the construction contingency reserve to be set at a minimum of two percent of the construction contract, inclusive of the contractor's fee and hard and soft costs. This reserve is required under Options Two and Three.

The construction contingency reserve will be set up and fully funded as a cash contribution prior to or at the closing of the construction loan. The construction contingency reserve will be held and managed by the lender. The disbursement of funds from the construction contingency reserve will be made by the lender only for change order requests approved by the lender and an Agency representative.

Unused funds from the construction contingency reserve transferred to the O&M reserve cannot be released until the project reaches occupancy of 90% for 90 days at the underwritten NOI and all reserves remain fully funded. This requirement remains in effect notwithstanding that the lender has established an additional Lease-Up/Conversion reserve in lieu of the occupancy requirement as provided in Chapter 4.19.

The lender at its own discretion, may release unused funds in the construction contingency reserve to the borrower after all other reserve accounts are fully funded, construction/punch list items are complete, certificates of occupancy have been issued, all lien releases have been obtained, and the Agency's final inspections have taken place and are satisfactory. If the lender decides not to release the unused funds to the borrower then it must transfer those funds to the O&M account and inform the Agency. If any portion of the construction contingency reserve funds are used during the construction period, those remaining funds will be transferred to the O&M reserve account and will lose its identity as construction contingency funds.

◊ **Interest Credit Reserve (if Applicable)**

The interest credit reserve is to be established in order to pay the interest credit to the project in its first year of operations in lieu of the actual interest credit payments which are made in January of each year. The interest credit is payable annually in arrears after the first day of January following the project's first amortization payment. The interest credit reserve will be reimbursed to the borrower within 60 days of receipt of the interest credit payment to the lender.

◊ **Initial Deposit to the Replacement Reserve**

The Capital Needs Assessment and Capital Improvement Plan may call for a replacement reserve escrow that requires an initial deposit to the replacement reserve. The reserve account balance must meet or exceed a $1,000/unit threshold by year three. Such an initial deposit is typically associated with a rehabilitation project and not with new construction. See Paragraph 7.13 for further details. For new construction projects, the reserve deposit will be based upon local fixture costs, age, and conditions.

SECTION 4: PROPERTY REQUIREMENTS

3.11 OVERVIEW

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

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

3.12 RURAL AREA DESIGNATION

Lenders must verify that projects are located in an area that meets the Agency's definition of a rural area (see Paragraph 1.6). Lenders may verify eligibility at https://eligibility.sc.egov.usda.gov/eligibility.

3.13 GENERAL SITE REQUIREMENTS

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

A. Public Facilities and Services

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

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

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

B. Less Desirable Areas

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

Examples of Less Desirable Areas

Examples of less desirable areas include:

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

3.14 SITE STANDARDS

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

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

Technical Assistance on Site Standards

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

A. Applicable Codes

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

B. Adequate Utilities and Infrastructure

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

C. Grading and Drainage

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

D. Size and Shape

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

E. Undesirable Physical Conditions

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

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

3.15 SITE DENSITY

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

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

3.16 NON-CONTIGUOUS SITES

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

- Located in one market area (a neighborhood or similar area where the property competes for tenants);

- Managed under one management plan and one management agreement; and
- In sufficiently close proximity to permit convenient and efficient management of the property.

3.17 SITE CONTROL

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

A. Land Ownership

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

B. Land Lease

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

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

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

- The lessor must authorize the proposed improvements required by the guaranteed mortgage;

- The lessor must authorize the lender and Agency the right to foreclose the guaranteed mortgage or to transfer the lease if the borrower defaults;
- The lender or the Agency are permitted to bid at a foreclosure sale or to accept deed in lieu of foreclosure;
- The borrower is permitted to transfer the leasehold as part of an ownership transfer of the property, in the event of default or inability to continue with the lease; and
- The lessor gives the Agency and the lender notice of lease default and a 60-day period of time for the Agency or lender to cure the default.

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

3.18 ENVIRONMENTAL REQUIREMENTS

To protect the environment and to ensure the value of a guaranteed loan, the Agency must undertake an environmental review. The Agency will request assistance of the lender in conducting this review. Agency staff will initiate the governmental review process after the lender submits *Form RD 1940-20, "Request for Environmental Information",* and supporting documentation. The environmental review entails the publication of a public notice regarding the project and written feedback from different State and local offices concerned with environmental issues. The environmental review is complete only after the publication period of the public notice has expired, and the State Environmental Coordinator signs the appropriate documents. The environmental review takes at least 45 days to complete. More time will be needed if State and local environmental authorities have any findings. Delays in the environmental review process are certain if the project location is on an archaeological burial site, in flood plains, or protected areas. Properties must meet the Agency environmental standards in Chapter 11 and in 7 CFR Part 1970, Executive Order 12898 and Departmental Regulation 5600-002.

A. Lender Responsibilities Prior to Requesting Guarantee

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

B. Agency Environmental Review

The National Environmental Policy Act (NEPA) requires Federal agencies to take into consideration the potential impacts of a proposed project on the human environment and on any protected environmental resources in the vicinity of the proposed site. Therefore, prior to loan approval, obligation of loan funds, issuance of a conditional commitment, or other commitment of Agency resources, whichever occurs first, a NEPA environmental review must be completed and conducted in accordance with 7 CFR part 1970. The environmental review examines the environmental consequences of the proposed action and ensures that alternatives are developed and incorporated into the proposal to either avoid environmental impacts or to mitigate adverse effects to the environment. Further information is found in Chapter 11. The applicant is responsible for conducting the NEPA review. For projects with 5 - 12 units, the Agency, at its discretion, may conduct the review for the applicant.

3.19 CIVIL RIGHTS

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

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

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

Guidance on the civil rights impact analysis can be found in RD Instruction 2006-P. This form should be completed and filed with the Agency's Environmental file folder.

3.20 PROJECT DEVELOPMENT

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

A. Project Size

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

B. Agency Construction Requirements

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

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

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

- The portion of the program authority guaranteed funds for acquisition with rehabilitation may be limited depending on program goals;
- Rehabilitation requires replacement or alteration of building spaces, mechanical systems, or project facilities;
- Existing structures must be structurally sound and functionally adequate prior to the start of repair work;
- Per unit rehab costs must be at least $6,500 or more; and
- When completed, the rehabilitated building(s) must be energy efficient and in “like new” condition.

Rehabilitation with a stay-in-owner is permitted, subject to the following conditions:

- Rehab costs must be at least $6,500 per unit and the rehab renders the project in like-new condition [and energy efficient] as corroborated by an Agency approved C.N.A. that shows no deferred maintenance and that no repairs will be needed for at least the next 5 years.

- The owner/borrower (or any of its principals) cannot receive any payments/compensation/fees/cash-out (as consultants, developer, contractor (general or sub), equity, etc.) from the guaranteed loan funds.

C. Federal Accessibility Requirements

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

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

- **The Fair Housing Act** (42 U.S.C. 3601-19) requires that multifamily dwellings meet the design and construction requirements at 24 CFR 100.205 that implements the Fair Housing Act.

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

Exhibit 3-2

Section 504 Requirements

Removal of Physical Barriers

For **new construction** of multifamily projects, five percent of the units in the project (but not less than one unit) must be accessible to individuals with mobility impairments, and an additional two percent of the units (but not less than one unit) must be accessible to individuals with sensory impairments.

- The Section 504 definition of **substantial rehabilitation** multifamily projects includes construction in a project with 15 or more units for which the rehabilitation costs will be 75 percent or more of the replacement cost. In such developments, five percent of the units in the project (but not less than one unit) must be accessible to individuals with mobility impairments, and an additional two percent (but not less than one unit) must be accessible to individuals with sensory impairments.
- When **rehabilitation less extensive than substantial rehabilitation** is undertaken, alterations must, to the maximum extent feasible, make the unit accessible to and usable by individuals with disabilities until five percent of the units are accessible to people with mobility impairments. Alterations to common spaces must, to the maximum extent feasible, make the project accessible.
- Accessible units must be, to the maximum extent feasible, distributed throughout projects and sites and must be available in a sufficient range of sizes and amenities so as not to limit choice.
- Owners and managers of projects with accessible units must adopt suitable means to ensure that information regarding the availability of accessible units reaches eligible individuals with disabilities. They also must take reasonable non-discriminatory steps to maximize use of such units by eligible individuals.
- When an accessible unit becomes vacant, before offering the unit to a non-disabled individual, the owner/manager should offer the unit, first to a current occupant of the project requiring the accessibility feature and second to an eligible qualified applicant on the waiting list requiring the accessibility features.
- The usual standards for ensuring compliance with Section 504 are the Uniform Federal Accessibility Standards (UFAS), although deviations are permitted in specific circumstances.

Provide Program Accessibility

- Individuals with disabilities must be able to learn of, apply for, and participate in Federally-assisted programs or activities.
- Special communication systems may be needed for outreach and ongoing communication (e.g., Telecommunications Devices for the Deaf (TDD), materials on tape or in Braille, or disabled-accessible locations for activities and meetings).
- Policies and procedures must be non-discriminatory (e.g., housing providers may not ask people with disabilities questions not asked of all applicants, screen individuals with disabilities differently, or assess an individual's ability to live independently).

Make Employment Accessible

- Employers must not discriminate.
- Employers must remove physical and administrative barriers to employment.
- Employers must make reasonable accommodations for individuals with known disabilities (e.g., job restructuring, providing readers or sign interpreters, or making facilities accessible).

Administrative Requirements

If recipients or sub recipients have 15 or more employees, they must:

- Designate a Section 504 Coordinator; and
- Notify program participants and employees of non-discrimination policies.

All recipients and sub recipients must conduct self-evaluations of compliance with Section 504.

SECTION 5: FINANCING TERMS

3.21 OVERVIEW

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

3.22 OCCUPANCY AND RENT RESTRICTIONS

The guaranteed loan program contains three distinct features with respect to affordability of units. Lenders must ensure that loans are underwritten and that mortgage documents adequately address these restrictions. GRRHP income limits can be found on the Rural Development website at Multifamily Housing Loan Guarantees.

- **Tenant Income Restrictions**. At initial occupancy, tenancy is restricted to individuals and families whose incomes do not exceed 115 percent of AMI (adjusted for family size). The tenant income restriction must be supported by a deed restriction for each GRRHP loan guarantee.

- **Rent Restrictions**. At rent up and on a continuing basis thereafter, rents on any GRRHP unit, including tenant paid utility allowances, may not exceed 30 percent of 115 percent of AMI (adjusted for family size). In addition, the average rent for the entire project, including any tenant paid utilities, may not exceed 30 percent of 100 percent of AMI (adjusted for family size). For this purpose, the Income Limits can be found on the Rural Development website at Multifamily Housing Loan Guarantees.

- **Deed Restrictions.** The property must remain as affordable rental housing for the original loan term. To ensure compliance with this requirement even if the loan is prepaid, restrictive language must be recorded in the deed or any other instrument that conveys with the property if the mortgage is prepaid. Sample language is provided in Exhibit 3-3.

Exhibit 3-3
Sample Restrictive Language for Deeds

Example I: If the guaranteed loan is being used to finance the purchase of the property and the construction of the affordable rental housing, the following restriction would be placed on the deed:

"The owner(s), for themselves and their successors in interest, agree that until (insert date), the property can only be utilized as rental housing (not homeownership) and can only be leased to low or moderate income families or persons, whose incomes at the time of initial occupancy do not exceed 115 percent of the median income of the area (Eligible Tenants), as determined by the United States Department of Agriculture in accordance with 42 U.S.C. 1490p-2. No Eligible Tenant occupying the housing will be required to vacate nor any Eligible Tenant denied occupancy in violation of this provision. This restriction is enforceable by Eligible Tenants or the United States Department of Agriculture. For further questions, contact the United States Department of Agriculture, Rural Housing Service, Director of Multi-Family Housing Production and Preservation Division, 1400 Independence Avenue, SW, Room 5017-S, Washington, DC 20250."

Example II: If the applicant already owns the property, the lender will need to create and file a deed declaration in the suggested format:

"The owner(s), for themselves and their successors in interest, agree that until (insert date), the property can only be utilized as rental housing (not homeownership). The following property

[Legal description of property]

can only be leased to low or moderate income families or persons, whose incomes at the time of initial occupancy do not exceed 115 percent of the median income of the area (Eligible Tenants), as determined by the United States Department of Agriculture in accordance with 42 U.S.C. 1490p-2. No Eligible Tenant occupying the housing will be required to vacate nor any Eligible Tenant denied occupancy in violation of this provision. This restriction is enforceable by Eligible Tenants or the United States Department of Agriculture. For further questions, contact the United States Department of Agriculture, Rural Housing Service, Director of Multi-Family Housing Guaranteed Loan Division, 1400 Independence Avenue, SW, STOP 0781, Washington, DC 20250."

3.23 USE OF LOAN PROCEEDS

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

A. Eligible Uses of Loan Proceeds

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

- New construction;
- Rehabilitation of buildings and acquisition costs when related to the rehabilitation;
- Acquisition of existing buildings, when approved by the Agency, for projects that serve a special housing need;
- Acquisition and improvement of land on which housing will be located;
- Development of on-site and off-site improvements essential to the use of the property;
- Development of related facilities such as community space, recreation, storage, or maintenance structures, except that any high cost recreational facility, such as swimming pools and exercise clubs or similar facilities, must be specifically approved by the Agency;
- Construction of on-site management or maintenance offices and living quarters for operating personnel for the property being financed;
- Purchase and installation of appliances and certain approved decorating items, such as window blinds;
- Development of the surrounding grounds, including parking, landscaping, and fencing;
- Costs associated with commercial space provided that:
  - ◊ The project is designed primarily for residential use;
  - ◊ The commercial use consists of facilities such as laundry rooms, that are considered essential and not conveniently available; and

   ◊ The commercial space does not exceed 10 percent of the gross floor area of the residential units and common areas, and the commercial income does not exceed 10 percent of total project income, unless a higher level is specifically approved by the Agency.

- Costs for feasibility determination, loan application fees, appraisals, environmental studies, professional fees or other fees determined by the Agency to be necessary to the development of the project;
- Technical assistance to and by non-profit entities to assist in the formation, development, and packaging of a project or formation or incorporation of a non-profit borrower entity;
- Education programs for a board of directors, both before and after incorporation of a borrower entity that will serve as the borrower;
- Construction interest;
- Relocation assistance, in the case of rehabilitation projects;
- Developers' fees; or
- Repaying applicant debts when:

   ◊ The Agency authorizes the use of loan funds to pay debts for work, materials, land purchase, or other fees and charges before the loan closed; or

   ◊ The Agency concurs with a determination by the lender that costs of work, fees, and charges incurred prior to loan application are integral to development of the guarantee application and project.

B. Ineligible Uses of Loan Proceeds

Loan proceeds must not be used for the following:

- Specialized equipment for training or therapy;
- Student housing;
- Housing in military impact areas - military impact area is defined in Exhibit 3-4 of this chapter;
- Cooperative Housing;
- Housing that serves primarily temporary and transient residents, such as students;
- Special care facilities and institutional type homes that require licensing as a medical care facility;

Exhibit 3-4

A military impacted area is generally a housing market in which:

1. Military-connected households comprise 25 percent or more of the total households (NOTE: Military-connected households are those households comprised of military personnel and civilian employees of the installation and their dependents); and or

2. The closure of the installation or reduction in military-connected households will destabilize the housing market, resulting in a rental vacancy rate above 10 percent for a period of 2 or more years; or

3. There is concern about the continued stability of the local housing market based on DOD's plans to change the installation's mission and reduce military strength and civilian employment.

A military impacted area generally would be a small metropolitan area or a nonmetropolitan housing market.

It is unlikely that installations in large metropolitan housing markets will meet the above criteria.

- Operating capital for central dining facilities or for any items not affixed to the real estate, such as special portable equipment, furnishings, kitchenware, dinnerware, eating utensils, movable tables and chairs, etc.;

- Payment of fees, salaries, and commissions or compensation to borrowers, with the exception of developers' fees; or

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

3.24 APPLYING SECTION 207(c) LOAN LIMITS

The loan amount must not exceed the applicable maximum per dwelling unit limitations amended by H.R. 1629, dated April 26, 2001, of Section 207(c)(3) of the National Housing Act. The limits are published by HUD, but the lender should contact the local HUD Multifamily Hub or Program Center Office as adjustments to the limits are made for different locales. The Secretary of HUD may increase these limits up to an amount not to exceed 110 percent in any geographical area where the Secretary finds that cost levels so require, and up to 140 percent on a project-by-project basis where the Secretary determines it is necessary. The amount also may be increased by up to 20 percent, if necessary, to account for the cost of installation of certain energy improvements. Prior to closing, lenders must also certify that the limits under 207(c) (3) have not been exceeded. Lenders should refer to HUD Notice H2001-10. The Notice, available at http://portal.hud.gov/portal/page/portal/HUD/program_offices/administration/hudclips/notices/hsg, contains the methodology used to determine costs not attributable under Section 207 (c)(3).

3.25 MORTGAGE TERMS

A. Maximum Loan Term

Where the transaction includes a construction loan guarantee under Option Two or a continuous guarantee under Option Three, the lender is expected to determine the construction loan term, which cannot exceed 24 months.

The Agency must review the construction period and determine that it is appropriate.

The lender is expected to determine the loan's repayment term. However, the repayment term cannot exceed 40 years (including the construction period) or the remaining economic life of the project, whichever is less. Where interest rates available on shorter term loans result in lower unit rents, lenders are encouraged to make shorter, fully amortizing loans. The Agency will not permit negative amortization during the term of the loan.

Loans guaranteed by the GRRHP must have a term of not less than 25 and not more than 40 years from the date of the loan. The loan amortization period cannot be less than 25 years or more than 40 years. The final payment of the balance is due at the end of the loan term. The Agency may accept requests from lenders to restructure the loan terms of prior awards accordingly

B. Maximum Interest Rate

The interest rate on the loan will be the negotiated rate between the lender and the borrower. If a maximum rate is established by the Secretary, the negotiated rate aforementioned cannot exceed the maximum allowable rate. The loan must bear a fixed rate of interest over the entire term.

C. Interest Rate Reduction (Interest Credit), if Applicable

When authorized by Congress, the Agency may provide additional financial assistance by providing an interest credit to reduce the interest rate. The interest rate was previously reduced to the Long Term Monthly Applicable Federal Rate (AFR). However, the use of the AFR was eliminated by the enactment of the Housing and Economic Recovery Act of 2008.

The lender and borrower have two options for calculating the rate to the borrower:

- Option 1 – Apply the interest credit amount to a new loan note guarantee's interest rate negotiated between the borrower and the lender. The lender may change the previously calculated effective interest rate to the borrower. The new effective rate may be higher than the previously negotiated rate.
- Option 2 – Continue to process these deals with the existing loan note guarantee's interest rate under the program guidance in effect at the time the conditional commitment was issued, thereby not changing the effective interest rate to the borrower.

The interest credit is payable annually in arrears after the first day of January following the project's first amortization payment.

Interest credit awards are competitive. They are based on criteria and a scoring threshold. No more than the amount established by the Agency will receive interest credit. Lenders must separately amortize the loan amount that receives interest credit from the loan amount that is not eligible for the interest credit award. The interest credit will be payable the following January 1 of the year in which the project has reached occupancy standards, and/or the construction guarantee has converted to a permanent guarantee.

D. Maximum Loan Amount

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

1. Determining Maximum Loan-to-Value

For borrower entities that are not State, local, or tribal government bodies, or non-profit organizations, the guaranteed loan cannot exceed 90 percent of the total development cost or property value (as determined by the lender), whichever is less. Non-profit entities, public agencies, and Indian tribes may borrow up to 97 percent of the lesser of total development cost or appraised value. In order to mitigate the Government's exposure on high loan-to-value (LTV) loan guarantees, 75% and higher LTV loans guarantees may be required to pay down a portion (i.e., 10%) of the guaranteed loan's principal before any distributions of excess cash flow to borrower/owners are allowed.

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

2. Other Financing Sources

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

SECTION 6: DETERMINING PROPERTY VALUE

3.26 OVERVIEW

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

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

3.27 CASH FLOW ANALYSIS

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

A. Operating and Maintenance Expenses

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

- **Income Analysis**. The borrower must provide a schedule of proposed rents (exclusive of utility allowances) and any other project income. Supporting documentation must include rents, tenant paid utilities, and vacancy levels at comparable properties. Exhibit 3-5 outlines how the income side of a project budget is constructed.

- **Operating Cost Projections**. These are estimated operating expenses, including costs of maintenance, repairs, utilities, and taxes. These estimates must be based upon the specific requirements of the subject property. Borrowers should support estimates with written documentation, when possible. Exhibit 3-6 outlines how the expense side of the projected budget is constructed.

Exhibit 3-5

The Income Projection

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

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

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

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

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

B. Debt Service

In determining value, lenders must consider whether the property will generate sufficient NOI to pay debt service and provide a return to the owner. A rule of thumb for rental properties is that properties must have sufficient net income to provide a reasonable cash surplus after expenses, or "debt service coverage." Debt service coverage (DSC) is the ratio of annual NOI to the annual mortgage principal and interest payment. The Agency requires lenders to use DSC of at least 1.15, unless the lender justifies a lower ratio and receives Agency approval. The NOI and DSC calculations are shown in Exhibit 3-7.

Exhibit 3-6

The Expense Projection

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

- Rental expenses (marketing, promotions, rent concessions);
- Management costs or fees;
- Financing costs such as bond financing expenses;
- Annual renewal and one-time guarantee fees (if applicable);
- Inspection fees;
- Utility and maintenance costs; and
- Taxes and insurance.

Sources of information for this part of the pro-forma include:

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

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

Exhibit 3-7

NOI and DSC Calculations

NOI and DSC are important terms used in underwriting a loan. NOI is total project income minus expenses.

Total income - Total expenses = NOI

DSC is the ratio of NOI to the annual principal and interest (P&I) payments on the mortgage.

DSC = Annual NOI ÷ Annual P&I Mortgage Payment

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

Example: A project is estimated to have an annual NOI of $103,500 and annual mortgage payments of $90,000. The DSC is $103,500 ÷ $90,000, or 1.15.

3.28 APPRAISAL

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

A. Appraisal Requirements

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

Appraisals used for Agency decision-making must be *current*. A *current appraisal* is an appraisal with a report date that is not more than one year old. A current appraisal is required before the loan guarantee is issued.

B. Appraiser Qualifications

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

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

C. Appraisal Methods

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

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

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

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

D. Appraisal Report Guidelines

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

E. Market Study

A separate market study will be conducted and it must include the material listed in Exhibit 3-8.

Exhibit 3-8

Required Contents of a Market Study

The market study must include:

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