CHAPTER 7. LOAN UNDERWRITING GUIDELINES
MAKING A FINAL DECISION ON THE LOAN

7-1. INTRODUCTION. This Chapter details the requirements for underwriting Section 312 Rehabilitation Loans -- that is, for determining if the borrower is an acceptable credit risk -- and for making a final decision as to whether or not the loan is to be made.

In order to keep the program financially solvent, the Federal subsidy on Section 312 loans must be limited to the interest rate; underwriting criteria must not be compromised to assist borrowers who are poor credit risks. In addition, loans made to borrowers who cannot afford them will be damaging to the borrowers as well, since they are likely to default, damage their credit rating, and possibly lose their property in foreclosure proceedings.

Therefore, loans must be made only when the borrower is likely to repay and when there is adequate security in case the borrower defaults. LPA's are required to assist the Federal government to minimize the losses under the Section 312 Program by evaluating the financial risks involved in each individual case and rejecting those applications deemed unacceptable.

The process of evaluating the risk factor of any give borrower involves assessing a wide range of variables, including the borrower's income, housing costs and long-term credit history, in addition to the value of the property, the borrower's motivation to retain the property, and the adequacy of the proposed rehabilitation. Each of these variables must be assessed independently and together with the others in order to make a determination about the overall degree of risk.

There are five key variables which the LPA and HUD must evaluate when underwriting loans to determine if the potential borrower is an acceptable risk:

a. Affordability;

b. Credit history and financial interest in the property;

c. The value of the security;

d. The scope of the proposed rehabilitation work; and

e. Property management and availability of cash (for investor-owners only).

These variables are discussed in the paragraphs below, first for loan to owner-occupants, then for loans to investor-owners. The Chapter also includes a listing of the data local officials must utilize in making their underwriting decisions, a discussion about putting all the information together to make a final decision about the loan. A description of the requirements of the Equal Credit Opportunity Act of 1976 as they relate to making decisions about potential borrower's ability to repay the loan and their credit worthiness is contained in Paragraph 12-7).

The requirements and guidelines detailed in this Chapter are based, in part, on the guidelines used by Federal Home Loan Mortgage Corporation (Freddie Mac) for purchasing mortgages and home improvement loans from private savings and loan institutions throughout the country. This was done so that the Section 312 Program procedures would conform more closely to those used by private lending institutions, thereby enabling local officials to more easily coordinate their Section 312 efforts with private lending institutions.

Where possible, this Handbook has established strict underwriting guidelines which must be followed. However, these guidelines cannot deal with every contingency. In these cases, LPA's must use sound judgement in applying the principles established here. For instance, when evaluating if an owner-occupant of a single-family property has sufficient income to support a Section 312 Loan pursuant to Paragraph 7-5-a-(2), LPA's must include income only if its "continuation is probable based on foreseeable economic conditions." LPA's must use their sound judgement when deciding if a self-employed person's income is likely to continue, such as by determining if he/she has the necessary training and experience to continue to earn an income that will support a Section 312 Loan.

7-2. DATA LPA'S MUST USE TO MAKE UNDERWRITING DECISIONS. The LPA must obtain and use the following data to make their underwriting decisions, all of which data must meet the requirements of Chapter 4 on initial screening and Chapter 5 on verifications:

a. A signed loan application (see Paragraph 4-1 of this Handbook);

b. A credit report on the borrower and anyone else signing the note and security instrument (see Paragraph 5-3 of this Handbook);

c. Verification of income and employment information on the potential borrower and anyone else signing the note and security instrument (see Paragraph 5-5 and 5-7 of this Handbook);

d. Verification of the borrower's ability to provide additional funds for rehabilitation, if required (see Paragraph 5-6 of the Handbook);

e. The status of any outstanding mortgage and monthly mortgage payments, information as to whether the prior lien secures future advances or involves a balloon payment, information confirming a real estate tax and/or insurance escrow account, and pay-off requirements if refinancing is involved (see Paragraph 5-4 of this Handbook);

f. Evidence of acceptable title on the property (see Paragraph 5-9 of this Handbook);

g. An appraisal of the after-rehabilitation value of the property (see Paragraph 5-10 of this Handbook);

h. A work write-up and/or property inspection report (see Paragraph 6-4 of this Handbook);

i. A firm estimate of the cost of the proposed rehabilitation work and/or the bid from the contractor selected to undertake the work (see Paragraph 6-5 of this Handbook);

j. Information gathered in conjunction with an environment assessment covering the proposed rehabilitation. Although the actual assessment need not be completed and approved by HUD until just prior to loan approval, it is important to identify any compliance actions or other items which could affect the cost or feasibility as early in the process as possible. For instance, an early determination must be made as to whether the property is located in a Federally-designated special flood hazard area, in which case the potential borrower must pay flood insurance premiums and the property may require flood-proofing and/or elevation (see Paragraph 12-8 of this Handbook);

k. Additional supplemental statements and clarifications as necessary.

7-3. DETERMINING THE LOAN AMOUNT

a. Before the loan can be underwritten, the LPA must calculate the exact size of the Section 312 Loan. The Loan amount is determined by adding all of the following:

(1) The cost of the proposed rehabilitation work;

(2) Interest on Section 312 drawdowns which will accrue during the construction period (often called Accrued Construction Interest), as detailed in Paragraph 7-3-b of this Handbook;

(3) Contingency reserve, pursuant to Paragraph 3-2-f of this Handbook;

(4) The application fee and the processing, settlement, taxes and

other costs to be included in the loan (if eligible pursuant to Paragraph 3-1 and 3-2 of this Handbook);

(5) Any existing debt being refinanced with the Section 312 Loan, if eligible pursuant to Paragraph 3-3.

b. General Information on Calculating Accrued Construction Interest

(1) Determining Construction Period. In order to estimate the interest on the Section 312 Loan drawdowns that will accrue during the construction period, the LPA must first determine how long the construction will take. The estimated construction period should be long enough to cover routine and ordinary delays as well as the amount of time necessary to complete the work. The period should take into consideration any anticipated delay between settlement and start of construction. The construction period should also be estimated by taking into consideration the time of year in which the loan is made, such as delays caused by harsh winter weather. See the Cash Management Notice, Paragraph 2, Section G, for more specific requirements on accrued construction interest and AED's.

(2) Establishing an Amortization Effective Date (AED). The AED should be established as the first of the month following construction completion. See Paragraph 9-2-a-(2) for additional information on establishing and changing the AED.

(3) Calculating Interest Accruing During Construction. Interest must be calculated to cover drawdowns from settlement through the AED. To calculate this accrued interest, LPA's should divide the total of all other loan costs by two, then multiply the result by the daily interest factor, and then multiply this result by the number of days between the date of settlement and the AED. (This figure must be adjusted if large early draws are anticipated, such as for refinancing, because this will increase the construction interest.) The daily interest factor should be obtained by dividing the contract interest rate on the Section 312 Loan by three hundred and sixty. The risk premium is not included in this calculation because no risk premium is charged on the loan until the start of amortization.

7-4. ROLE OF LPA, HUD FIELD OFFICE AND HUD HEADQUARTERS IN UNDERWRITING LOANS. (See Paragraph 8-2 for information on the process for loan approval.)

a. Loans for Single Family Properties Made in LPA's with Local Loan Approval Authority must be underwritten and, if they meet the requirements of this Handbook, approved by the LPA.

b. Loans Exceeding $200,000 must be underwritten and submitted for approval in accordance with the following procedures:

(1) LPA's must do the initial screening, verifications and underwriting, and then submit applications acceptable to them to the HUD Field Office with the LPA's formal recommendation for approval;

(2) The HUD Field Office staff must then underwrite the loan on its own and submit applications acceptable to them, along

with the Field Office Director of Community Planning and Development's formal recommendation for approval, to the Office of Urban Rehabilitation in HUD Headquarters;

(3) The HUD Headquarters Office of Urban Rehabilitation staff must then consult with the Field Office, review the application, and if acceptable, approval will be given by the Director of the HUD Headquarters Office of Urban Rehabilitation;

(4) The HUD Field Office must submit the loan for fund obligation in accordance with the requirements in Chapter 8 of this Handbook;

(5) The following additional requirements apply for these loans:

(a) The LPA or HUD Field Office may at any time reject an application that does not meet the requirements of this Handbook without submitting the application for a higher level review. If the application is rejected by the LPA or HUD Field Office, the LPA must so inform the applicant.

(b) In order to expedite this process, LPA's and HUD Field Offices should initiate a dialogue with HUD headquarters staff at the earliest possible time and throughout the process to raise underwriting and other issues. This informal communication will expedite the decision-making process at all level.

c. Refinancing must be underwritten by the LPA, but must be submitted to the Director of Community Planning and Development in the HUD Field Office for review and approval.

d. Loan Assumptions must be underwritten by the Master Servicer and submitted to the Office of Urban Rehabilitation in HUD Headquarters for approval (see Paragraph 7-7 of this Handbook for additional details on processing loan assumptions).

e. All Other Loans must be underwritten by the LPA, but must be submitted to the Rehabilitation Management Specialist in the HUD Field Office for review and approval.

7-5. UNDERWRITING LOANS TO OWNER-OCCUPANTS OF ONE-TO-FOUR UNIT PROPERTIES. This Paragraph applies to loans to owner-occupants of one-to-four unit properties only. It does not apply to any investor-owners of one-to-four unit properties, or to any multifamily, congregate, cooperative, single-room occupancy, non-residential or mixed-use properties. Each of the four key underwriting variables for these loans, along with the standards which must be applied for loans to owner-occupants of one-to-four unit properties, is discussed below:

A. Affordability

(1) General Principles. The LPA must determine whether each borrower's income is sufficient to meet all obligations promptly, including housing payments. As such, each borrower's total monthly housing expenses, including the repayment of the Section 312 Loan and payments for all debt secured by the property, must not exceed twenty-eight percent (28%) of the borrower's "stable monthly income." (For a description of stable monthly income, each Paragraph 7-5-a-(2) of this Handbook.) In addition, each borrower's total monthly debt payments, including total monthly housing expenses (as above) as well as all other payments on installment loan debts, must not exceed thirty-six percent (36%) of the borrower's "stable month income." (See Paragraphs 7-3-a-(3) and 7-3-a-(4) of this Handbook for a more detailed discussion of how these percentages are calculated, and how to deal with balloon notes and adjustable rate and graduated payment mortgages.) It is important to note that a similar analysis of the potential borrower's ability to afford a Section 312 Loan should have been conducted as part of the initial screening process (see Paragraph 4-7). That initial assessment was based on unverified income and employment data, and not necessarily on "stable monthly income", and it must be re-examined, based on the verified information, as part of this final underwriting analysis.

(2) Stable Monthly Income

(a) General Principles. Stable monthly income is the borrower's verified gross monthly income from primary employment base earnings plus recognizable secondary income, such as bonuses, commissions, fees, income from investments, regular over-time or part-time employment and retirement income. Funds withheld by an employer for such items as income or Social Security taxes must be included in stable monthly income. Monies may be counted as secondary income only if verified and substantiated by the borrower's previous two years' earning. If funds are included as "stable monthly income" for the purposes of

underwriting in accordance with this Chapter, they must also be included for the purposes of determining the borrower's eligibility for a three percent (3%) Section 312 Loan in accordance with Paragraph 2-3 of this Handbook, except as provided for in Paragraph 4-6-c of this Handbook. See Paragraph 4-6 for additional information on what income to include.

(b) Likelihood of Continuation. Primary employment base income and secondary income can be included only if continuation is probable based on foreseeable economic circumstances. For instance, an individual who has performed satisfactorily for his or her employer for a considerable time is unlikely to be fired or laid off. On the other hand, a borrower who is approaching a mandatory retirement age or in poor health may not reasonably be expected to continue to obtain employment income, and the LPA must look at the potential for pension or Social Security income. In addition, temporary income, such as short-term disability benefits, may not be included as stable monthly income.

(c) Income From Other Individuals or Public Agencies to which the Borrower is Entitled. If a potential borrower chooses to disclose income from alimony, chile support or maintenance payments, or public assistance payments, or has contributions from family members or others closely related to the family life (particularly those who also occupy the property), the LPA must consider them only if they are verifiable and are likely to be consistently made. Factors that must be considered in determining the likelihood of consistent payments include the following:

1 whether the payments are received pursuant to a written agreement or court decree;

2 the length of time the payments have been received;

3 the regularity of receipt;

4 the availability of procedures to compel payment;

5 whether full or partial payments have been made;

6 the credit worthiness of the payor, including the payor's credit history when available.

(d) Co-Makers. Income from co-makers, endorsers, or guarantors may be included in stable monthly income only if the co-maker's or guarantor's income employment and credit can be verified in accordance with Paragraph 5-1 through 5-7

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of this Handbook, and if the co-maker meets the credit requirements of Paragraph 7-5-b of this Handbook. In addition, the applications must clearly reflect the capacity in which the co-signer will execute the loan note, and special care must be taken at loan settlement to assure that such execution actually takes place. The LPA must determine that the co-maker or guarantor is clearly motivated to help meet the loan payments and has the income available to do so. The co-maker's or guarantor's motivation will depend upon his or her relationship to the borrower, and whether or not he or she occupies or derives any other benefits from the property. The maximum amount of income from a co-maker or guarantor that can be included in the borrower's stable monthly income is the difference between the stable monthly income of the co-maker or guarantor and his or her monthly expenses. The endorsement or guarantee must not be qualified or limited in any manner. All underwriting criteria described in this Chapter and all verifications described in Paragraphs 5-1 through 5-7 of this Handbook apply equally to the credit evaluation of the co-maker or guarantor.

(e) Anticipated Increases. Anticipated increases in income which cannot be confirmed may not be included as stable monthly income.

(f) Extraordinary Medical Expenses. If the potential borrower or his or her family have extraordinary medical expenses which reliable medical opinion indicates are likely to continue for more than one year, and if their income was adjusted downward to qualify them for a three percent (3%) loan in accordance with the provisions of Paragraph 2-3-a-(3) of this Handbook, these expenses must again be deducted when calculating stable monthly income for underwriting purposes.

(g) Other Items to Consider. The LPA must also consider items such as the potential borrower's education, training, technical skills, occupation, and past employment history in determining whether any income should be included as stable monthly income.

(3) Monthly Housing Expense-to-Income Ratio -- Twenty-eight Percent (28%) Maximum

(a) Items Included In Monthly Housing Expenses. Monthly housing expenses is the sum of the following monthly charges on the mortgaged premises:

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1 principal and interest payments on all junior and senior debt secured by the property, but excluding debt which would be refinanced through the Section 312 Loan (see Paragraph 7-5-a-(3)-(c) and 7-5-a-(3)-(d) of this Handbook for additional information on balloon notes and adjustable rate and graduated payment mortgages);

2 principal and interest payments on the Section 312 Loan and on all other debt for supplemental financing necessary to complete the rehabilitation which would be secured by the property, regardless of whether this proposed debt would be junior or senior to the

Section 312 Loan (see Paragraph 7-3 of this Handbook on calculating the Section 312 Loan amount, and Paragraphs 7-5-a-(3)-(c) and 7-5-a-(3)-(d) of this Handbook for additional information on balloon notes and adjustable rate and graduated payment mortgages);

3 risk premiums for the Section 312 Loan, and, when applicable, mortgage insurance premiums for other debt secured by the property (see Paragraph 2-4-b of this Handbook for information on how to calculate the Section 312 risk premium);

4 hazard insurance premiums;

5 real estate taxes;

6 leasehold payments or ground rents (when applicable);

7 homeowners association dues or cooperative maintenance fees, excluding unit utility charges (when applicable).

(b) Items Not Included

1 maintenance costs;

2 utility payments.

(c) Balloon Notes or Open-Ended Mortgages. See Paragraphs 5-4-b and 5-4-c of this Handbook for conditions under which Section 312 Loans can be made if there is a balloon note secured by the property or an open-ended mortgage on the property.

(d) Adjustable Rate and Graduated Payment Mortgages. The LPA must determine if the existing payment for principal and interest, together with other debt secured by the property, meet the 28% requirements. However, the LPA must also estimate what the payments for principal and interest are

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likely to be over the next five years. This must be based, at least in part, on the limitations on increases in interest rates, if any, that are included in the notes. The loan must not be approved unless the LPA determines that it appears likely that borrower will be able to afford these additional monthly payments.

(e) Applying the Ratio. The monthly housing expense detailed above must not exceed 28 percent of the borrower's stable monthly income.

(4) Monthly Debt Payment-to-Income Ratio -- Thirty-Six Percent

(36%) Maximum

(a) Items Included in Monthly Debt Payment. The monthly debt payment is the sum of the monthly charges for the following:

1 monthly housing expenses (see Paragraph 7-5-a-(3)-(a) of this Handbook);

2 payments on installment loan debts with more than 10 remaining payments;

3 alimony, child support, or maintenance payments;

4 aggregate negative cash flow from all properties presently owned (except subject property);

(b) Applying the Ratio. The ratio of the borrower's monthly debt payment to the borrower's stable monthly income must not exceed thirty-six percent (36%).

(5) Exceptions for Extraordinary Circumstances. The monthly housing expense-to-income and monthly debt payment-to-income ratios detailed above must not be exceeded except in extraordinary circumstances, in which case written approval must be obtained from the HUD Field Office Director of Community Planning and Development. If such an approval is granted, the LPA must include a written justification in the case file. These exceptions may only be granted on a case-by-case basis, not on a blanket basis for some or all loans in a locality. Examples of conditions that could justify higher ratios include but are not limited to the following:

(a) the demonstrated ability of the borrower to successfully devote a greater portion of income to housing expenses;

(b) the demonstrated ability of the borrower to maintain an

excellent credit history, to accumulate savings, and to maintain a debt-free position;

(c) the substantial probability that the borrower's income will increase, based on his or her education, job training, or time employed or practiced in a profession;

(d) the borrower's net worth being substantial enough to evidence an ability to repay the loan regardless of income;

(e) the property being so energy efficient that it reduces energy costs significantly below that which is normal for the area.

b. Credit History and Financial Interest in the Property

(1) Credit History

(a) General Principles. The borrower must have a credit history that demonstrates a consistent ability to meet financial obligations when due. The LPA's determination about the borrower`s credit history must be based upon a credit report and other credit information that meets the requirements of Paragraph 5-3 of this Handbook.

(b) Factors Which Must Be Considered

1 Borrower's Attitude Toward Obligations. If the borrower has a recent and recurring history of making debt payments over thirty (30) days late, or of debts incurred at previous residences, or debts turned over to collection agencies or courts, he or she will in all likelihood continue to be a bad credit risk. Delinquency in payment of secured loans, mortgage loans, rent or other contractual obligations similar in character to a Section 312 Loan should be viewed as particularly serious warning signs for the LPA. Isolated instances of slow payment should not necessarily disqualify a borrower, but each instance must be explained to the satisfaction of the LPA, and must be documented in the borrower's loan file with a note signed by the borrower and acceptable to the Approving Officer. Applications from borrowers who have a consistent pattern of an unsatisfactory credit attitude must be rejected.

2 Foreclosure. Foreclosure or a deed-in-lieu of foreclosure should ordinarily make a borrower ineligible for a Section 312 Loan unless the action resulted from

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well-defined extenuating circumstances beyond his or her control which are not likely to repeat themselves, such as an illness not likely to repeat itself which caused temporary unemployment. If the loan is approved under these conditions, a letter of explanation, signed by the borrower and acceptable to the Approving Officer, must be included in the loan file.

3 Bankruptcy and Other Judgements. A single bankruptcy, creditor's settlement, or other judgement does not necessarily make a borrower ineligible for a Section 312 Loan. In such cases, the contributing causes of the borrower's poor payment record must be examined and allowances made for circumstances beyond the borrower's control. If the borrower has succeeded in

re-establishing a satisfactory credit standing for at least two years, his or her applications should not be disqualified solely on the basis of non-recurring past difficulties. If the bankruptcy was related to an impending mortgage foreclosure, this is more serious, and the rules governing foreclosures in Paragraph 7-5-b-(1)-(b)-2 must be adhered to. If a borrower has any bankruptcies or other judgements and the applications is approved, a letter of explanation, signed by the borrower and acceptable to the Local Approving Officers, must be included in the loan file.

4 Job Tenure and Changes in Residence. Frequent changes of employment or residence by the borrower within the recent past must be satisfactorily explained in a letter signed by the borrower and acceptable to the Loan Approving Officer, and included in the loan file. An evaluation must be made as to the probable stability of income. A borrower who exhibits frequent changes in residence, but who has demonstrated job stability or is in a line of work that is in continuing demand and has advancement possibilities, should receive favorable consideration, provided an ability to manage financial affairs has been demonstrated. Education or training that would strengthen job opportunities and earnings capacity must be viewed favorably.

A borrower who has changed jobs frequently for advancement within the same line of work must receive favorable consideration if there is evidence that the borrower is successful in that work, but has outgrown the opportunities provided by a previous employer. Frequent job changes without advancement or from one line of work to another could lead to unstable income,

but if stable income has been maintained by the borrower over the recent past, job hopping without advancement should not result in unfavorable consideration. An unstable employment history may be offset by the borrower's financial strength and by a history of meeting financial obligations when due.

(2) Financial Interest in the Property. The borrower's desire to repay a Section 312 Loan is directly related to the strength of the borrower's desire for continued ownership, and to the purpose for which the borrower owns the property. When the borrower resides permanently in and has significant equity in the property to be rehabilitation, his or her motivation to repay the loan is assumed to be very strong. Assuming that the borrower has sufficient income to repay the loan, the borrower may be a good credit risk even if he or she has a borderline credit history, because the borrower's substantial equity in the property will strongly motivate him or her to take whatever

steps are necessary to protect the investment and make the loan payments.

c. The Value of the Security

(1) General Principles. For borrowers getting three percent (3%) Section 312 Loans, the discounted value of the principal of the Section 312 Loan, plus the full amount of the principal on all other debt secured by the property which is senior to the proposed Section 312 Loan, cannot exceed eighty percent (80%) of the appraised, after-rehabilitation value of the property. For all other borrowers, the non-discounted, full amount of the principal of the Section 312 Loan, plus the full amount of the principal on al other debt secured by the property which is senior to the proposed Section 312 Loan, cannot exceed ninety percent (90%) of the appraised, after-rehabilitation value of the property.

(2) Why the Discounted Value of Section 312 Loan is Used For Three Percent (3%) Loans. For three percent (3%) Section 312 Loans, which are made far below market rate, the present value of the principal and interest that the government will be repaid after twenty (20) years (assuming the loan is made for the maximum term) will only be approximately fifty percent (50%) of today's value of the original loan, assuming a twelve percent (12%) discount rate. (The present value will be somewhat higher for terms shorter than twenty years.) As such, the Government is willing to discount the value of the Section 312 Loan for purposes of calculating the property's total debt-to-value ratio. By using a loan-to-value ratio similar to that used by private sector lenders, the Section 312 Program is structured in such a way that the Federal government will be able recover most

of its investment if the borrower defaults on the Section 312 Loan and the property is liquidated. At the same time, by using the discounted value of the Section 312 Loan -- the true value of the loan to the government -- the program is liberal enough to accomplish its public purpose: to improve homes in deteriorated neighborhoods with property values which do not currently justify investment by the private sector.

(3) Calculating Total Debt on the Property. For the purposes of underwriting Section 312 Loans, total debt secured by the property includes the following:

(a) The full amount of any liens superior to the Section 312 Loan (principal only) secured by the property; PLUS

(b) For borrowers getting three percent (3%) Section 312 Loans, one of the following, depending on which term is closest to the term of the Section 312 Loan:

1 Twenty (20) year term -- Fifty percent (50%) of the

principal of the Section 312 Loan;

2 Fifteen (15) year term -- Sixty percent (60%) of the principal of the Section 312 Loan;

3 Ten (10) year term -- Seventy percent (70%) of the principal of the Section 312 Loan;

4 Five (5) year term -- Eighty percent (80%) of the principal of the Section 312 Loan; OR

(c) For borrowers not getting three percent (3%) Section 312 Loans, the full amount of the principal of the Section 312 Loan.

(4) Revisions to Discount Percentages. HUD may periodically revise the discount percentages described in Paragraph 7-5-c-(3)-(b) to reflect changes in interest rates.

(5) Appraised After-Rehabilitation Value. The appraised after-rehabilitation value must be developed in accordance with Paragraph 5-10 of this Handbook.

(6) Mobile and Modular Homes. For mobile and modular homes, special care needs to be taken to evaluate the remaining economic life of the property after rehabilitation, the economic and construction feasibility of the rehabilitation, and compliance with applicable codes and standards after rehabilitation.

d. The Scope of the Proposed Rehabilitation Work.

(1) General Principles. The proposed work must be sound and it must be adequate to extend the useful life of the property and to protect the value of the security for the term of the Section 312 Loan. In addition, if the amount of the Section 312 Loan will not cover the total cost of rehabilitation, the borrower must have or be able to obtain sufficient funds to complete the rehabilitation without over-extending his or her ability to repay the debt.

(2) Soundness of Proposed Work. Poor workmanship, contractor problems, and insufficient quality or quantity of rehabilitation not only lead to complaints to the LPA and HUD; they often generate repayment problems. During loan underwriting, the LPA must make a determination that the proposed work is sufficient, and that the proposed contractor, if known, is willing and able to complete the job on a timely basis.

The LPA must pay particular attention to the following:

(a) whether all code-related requirements are being addressed;

(b) whether all compliance actions necessary to meet environmental requirements set forth in Paragraph 12-8 of this Handbook are being addressed. These include actions necessary to meet the Federally-designated special flood hazard area and historic preservation requirements;

(c) whether plans for building security are adequate, if applicable;

(d) whether the building design will cause any management problems, such as with trash removal, if applicable; and

(e) whether the size of the proposed units is realistic for the existing market, if applicable.

(3) Funds to Complete the Rehabilitation. In cases where additional funds, beyond those being provided through the proposed Section 312 Loan, are needed to complete the rehabilitation, the LPA must determine that the borrower has or is able to obtain these funds. If the funds are to be obtained through additional loans, the LPA must verify that these funds are indeed available to the borrower, and the LPA must add these funds to the calculations undertaken as part of Paragraph 7-5-a of this Handbook to determine if the borrower can afford to take on an additional loan. If the funds are to be provided from cash reserves or cash equivalents by the borrower, the sources, availability and liquidity of the additional funds must be verified. These additional cash reserves or cash equivalents may be cash on

deposit, cash on hand, cash surrender value of life insurance, proceeds from the sale of marketable securities or other assets, gifts of cash, or cash equivalents. If materials are to be supplied to by the borrower, they must be on-site by the time of settlement. See Paragraph 9-3-h of this Handbook for additional information on handling supplemental financing.

7-6. UNDERWRITING LOANS TO INVESTOR-OWNERS. This Section details the underwriting requirements for loans to investor-owners of one-to-four unit properties, and for all multifamily, congregate housing, cooperatives, single-room occupancy, non-residential and mixed-use properties. The LPA must ensure that Section 312 Loans are made to investor-owners only when the borrower is likely to repay and when there is adequate security in case the borrower defaults.

HUD or the LPA may choose to require, for the Government's benefit, that two or more separately deeded investor-owned properties which are in close proximity and are under common ownership and common property management be combined as one project and underwritten as a group. If they are combined in this way and the Section 312 Loan is approved, a single loan must be made to the group under one security instrument.

One additional introductory remark needs to be made about underwriting loans to corporations and partnerships. It is extremely difficult to evaluate the financial risks involved in making loans to these entities. If the LPA does not have qualified staff to evaluate loans to partnerships and corporations, it is strongly encouraged that they obtain assistance from others, such as more experienced lenders in the community or outside consultants.

When underwriting loans to investor-owners, the LPA must evaluate the same variables as they do with loans to owner-occupants. These are: (1) the affordability, (2) credit history and financial interest in the property, (3) the value of the security, and (4) the scope of the proposed rehabilitation work. For investor-owners, LPA's must also evaluate a fifth variable: property management and availability of cash. These five variables and the applicable standards which must be applied for investor-owners are described in the paragraphs below.

a. Affordability

(1) General Principles. For investor-owners, the LPA must determine if the annual rental income on the property is sufficient to support the Section 312 Loan. As such, net operating income (gross income, minus projected vacancies, minus all operating expenses except debt service) must be at least 110% of all debt service on the property. The investor-owner's projection of rehabilitation costs, after-rehabilitation rental income and operating expenses must be summarized on the Applications

completed as part of the initial screening process. (See Paragraph 4-7 of this Handbook and Exhibit 4-2 for additional information.)

(2) Gross Income and Effective Gross Income

(a) Determining What Level of Rent is Realistic

1 Residential Properties. It must be assumed that investor-owners rent their rehabilitated units at market rates that are reasonable and customary for the area. Where some or all of an investor-owned property is occupied by the owner (i.e., for a mixed-use or non-residential property), it must be assumed that the owner pays market rent for the space he or she uses, and the owner must demonstrate the financial ability to pay such rent. The LPA must determine if the rents proposed in the pre-application can be reasonably secured in the open market, and if they are within the range that tenants who are likely to occupy the property can reasonably be expected to afford. For loans to investor-owners of one-to-four unit residential properties, the investor-owner must present the LPA with either of the following to demonstrate that the proposed rents are reasonable: (i) three recent newspaper

advertisements demonstrating that other comparable units in the neighborhood are renting for similar prices, or (ii) a letter from a property management company with properties in the area documenting that other comparable units are renting for similar prices in the area, or (iii) an independent market and demand analysis prepared by a qualified expert, or (iv) a listing of comparable rents in an appraisal of the property done in accordance with Paragraph 5-10 of this Handbook. For all properties other than one-to-four unit residential properties, comparable rents must be included in an appraisal of the property done in accordance with Paragraph 5-10 of this Handbook, and the investor-owner must also present the LPA with one of items(i) - (iii) detailed in this paragraph above.

2 Cooperatives. For the purposes of this Paragraph, rental income for a cooperative is the payments made by shareholders to the cooperative.

3 Non-Residential Properties. If the owner is expecting to rent the rehabilitated space to a business, rent comparables for similar commercial space must be used to evaluate the proposed rent. If the commercial tenant is a business owned, in whole or part, by the building

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owner, the financial and operating statement of the business must be reviewed to determine the ability of the business to pay the rent.

(b) Determining a Reasonable Vacancy Rate. Investor-owners must include a vacancy factor in their income projections of at least five percent (5%) of gross income. The LPA should consider requiring borrowers to use higher vacancy factors when calculating project income, particularly for smaller properties or if prevailing conditions in the neighborhood or locality so dictate.

(c) Determining Effective Gross Income. Effective gross income is the total proposed, reasonable annual rent minus the reasonable vacancy factor.

(3) Operating Expenses. Investor-owners must present the LPA with a reasonable estimate of after-rehabilitation annual operating expenses. Operating expenses must include, if appropriate, administrative costs such as advertising and professional property management; ongoing operating expenses such as utilities, trash removal, elevator expenses and payroll; maintenance expenses such as repairs, grounds,

exterminating, supplies and furnishings; insurance; and taxes. In addition, operating expenses must include a replacement reserve of between two percent (2%) and five percent (5%) of gross annual rents. For the purposes of this Paragraph 7-6-a-(3), operating expenses must not include debt service or depreciation. The requirements of Paragraphs 5-4-b and 5-4-c of this Handbook concerning balloon notes and open-ended mortgages, and of Paragraph 7-5-aa-(3)-(d) of this Handbook concerning adjustable rate or graduated payment mortgages, must be complied with, as applicable. At a minimum (unless otherwise approved by the Field Office Director of Community Planning and Development, as detailed in this paragraph below), total projected operating expenses, excluding taxes, insurance and debt service, but including replacement reserves, must be at least eighteen percent (18%) of effective gross income if utilities for heating and/or cooling are paid by tenants, and at least twenty-four percent (24%) of effective gross income if utilities for heating and/or cooling are paid by the investor-owner. HUD expects actual operating expenses to exceed these minimums for most investor-owned projects, and LPA's and HUD Field Offices should consider requiring higher minimums in their areas if local conditions so dictate. The LPA may underwrite projects with lower expenses, if specifically approved by the HUD Field Office Director of Community Planning and Development, but only in the rare instances that it can be clearly demonstrated that costs will be lower, such as for certain projects that are owner-occupied and/or owner-managed

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(so long as the requirements of Paragraph 7-6-e of this Handbook concerning property management are met).

(4) Net Operating Income. Net operating income (NOI) is annual effective gross income minus total annual operating expenses, excluding debt service.

(5) Debt Service. Debt service includes debt service on the Section 312 Rehabilitation Loan, as well as all other proposed or existing rehabilitation debt plus all other mortgage loans on the property.

(6) Net Operating Income to Dept Service Ratio. Except as provided below in this Paragraph, the property must have a positive cash flow, excluding depreciation and other tax benefits; that is, net operating income must exceed all debt service, including debt service on the Section 312 Loan. This is represented by the Net Operating Income to Debt Service Ratio. Net operating income must be at least 110 percent of total debt service; that is, net operating income divided by total debt service must be at least 1.1. The LPA may grant exceptions to this rule, if approved by the HUD Field Office Director of Community Planning and Development. Such exceptions may be granted only if (i) the audited or

independently verified personal financial statements of borrower(s) personally signed the Section 312 note clearly indicate that they have the capacity to handle the negative cash flow, or (ii) if the borrower(s) provide letters of credit or pledged of assets necessary to cover estimated negative cash flow for five years from the expected date of settlement of the Section 312 Loan.

b. Credit History and Financial Interest in the Property

(1) The Potential Borrower's Credit History

(a) General Requirements. The borrower must have a credit history that demonstrates a consistent ability to meet his or her financial obligations on time. The LPA's determination about the borrower's credit history must be based upon a credit report and other financial information that meet the requirements of Chapter 5, and the credit requirements for owner-occupants detailed in Paragraph 7-5-b of this Handbook.

(b) Corporations. The LPA must comply with the requirements for obtaining a Dun and Bradstreet or equivalent report and/or a credit report for the corporation and principal officers and stockholders detailed in Paragraph 5-3-c of this Handbook. If the corporation is so new or small that it has no credit history, or if its credit report is not

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acceptable, the LPA must require the principals to personally co-sign the mortgage, note and/or deed of trust, and the principals must meet all the other requirements for co-makers of loans to owner-occupants. (See Paragraph 7-5-a-(2)-(d) of this Handbook.)

(c) Partnerships. If the borrower is a general or limited partnership, the LPA must obtain a credit report for the partnership and for general and limited partners (as applicable) in accordance with Paragraph 5-3-c of this Handbook. All general and limited partners (as applicable) must personally sign for the Section 312 Loan.

(d) Commercial Property. If the borrower is leasing the property to a business, a Dun and Bradstreet or equivalent report must be obtained for the business renting the property (if available) to determine if the business is likely to continue paying rent to the borrower.

(2) The Borrower's Financial Interest in the Property. The Amount of equity (appraised value less debt) which the

borrower will have in the property must be determined both before and after rehabilitation. At least 10% equity is required and the LPA or Director of Community Planning and Development in the HUD Field Office may require a larger equity investment. If the borrower has substantial equity at risk in the subject property, he or she can count on to make all reasonable efforts to protect his or her investment; alternatively, if the borrower has little equity at risk in the property, he or she is more likely to default and forfeit the minimal investment if the project begins to fail.

c. The Value of the Security

(1) General Requirements. For loans to all investor-owners described in the introduction to Paragraph 7-6, except for loans to cooperatives getting three percent (3%) Section 312 Loans, the outstanding debt secured by the subject property (principal only), including the full amount of the principal of the Section 312 Loan and any liens superior to the Section 312 Loan secured by the property, cannot exceed ninety percent (90%) of the appraised, after-rehabilitation value of the property. For loans to cooperatives getting three percent (3%) Section 312 Loans in accordance with Paragraph 2-3-1-(2) of this Handbook, the requirements of Paragraph 7-5-c-(3)-(b) of this Handbook concerning the valve of the security for loans to owner-occupants getting three percent (3%) Section 312 Loans must be met instead.

(2) Why this Loan-to-Value Ratio is Used. As with loans to owner-occupants, the loan-to-value ratio requirements are designed to enable the Federal government to recover most of the investment by liquidating the property if the borrower defaults on the Section 312 Loan. For loans to investors, the maximum loan-to-value ratio is ninety percent (90%), rather than the more conservative eighty percent (80%) required for owner-occupants of single-family properties with incomes below eighty percent (80%) of median income. In fact, the overall loan-to-value requirements for investors are more stringent than those for owner-occupants of single-family properties. This is because the three percent (3%) loans to owner-occupants of single-family properties with incomes below eighty percent (80%) of median income are discounted for the purpose of calculating the loan-to-value ratio. As a result, although the maximum permissible loan-to-value ratio for loans to investors is itself more liberal than that for 3% loans to owners of single-family properties, the overall loan-to-value requirements are more stringent for loans to investors.

(3) Applying the Loan-to-Value Ratio. For the purpose of underwriting and calculating the loan-to-value ration for investor-owners, the total debt on the property must be

determined by adding one hundred percent (100%) of the principal of the Section 312 Loan to the full amount of the principal on any liens superior to the Section 312 Loans which are secured by the property. This total debt on the property cannot exceed ninety percent (90%) of the after-rehabilitation value of the property.

d. The Scope of the Proposed Rehabilitation Work. All the requirements in Paragraph 7-5-d of this Handbook, concerning the scope of work for owner-occupants of single-family properties, must also be met for loans to investor-owners.

e. Property Management and Availability of Cash

(1) The Potential Borrower's Plan for Property Management. Failure to adequately manage any rental property is likely to result in lost revenue, increase tenant complaints, a reduced market demand for the units, and declining property value, all of which can render the property unprofitable and can result in eventual default on the rehabilitation loan. As a result, the investor-owner must supply the LPA with information about his or her plan for managing the property, indicating whether the property will be owner-managed or managed by a professional management firm.

(a) Owner-Management. If the owner is managing the property, the owner must demonstrate that he or she has the time, skill and experience necessary to do so. The potential borrower must also include the addresses of other

properties managed, if any, along with the number of units and the condition of the property, and this information must be verified by the LPA.

(b) Professional Management. If a professional management firm is managing the property, the borrower must adequately demonstrate that the firm has experience and expertise in property management. The borrower must submit the following to the LPA: a description of the firm, including the year organized; the type and variety of properties managed; the number of units and properties managed; and how long each has been managed by the firm. For very large, well known management companies, a list of five projects managed which are similar to the project under consideration may be substituted for the last two items.

(2) The Borrower's Availability of Cash. A financial statement must be obtained from the borrower which meets the requirements of Paragraph 5-5-f of this Handbook, and liquid assets must be verified in accordance with Paragraph 5-6.

The borrower's financial statement must demonstrate that he or she has sufficient cash to cover operating expenses and debt service during the rent up period after rehabilitation is complete, as well as expenses not includable in the Section 312 Loan, such as the cost of marketing newly rehabilitated units, and any other unforeseen contingencies. As a result, the borrower must have liquid assets to cover at least 3 months of principal, interest and risk premium payments on the Section 312 Loan and any other outstanding superior loans on the property. The liquid assets may be cash on deposit, cash on hand, cash surrender value of life insurance, proceeds from the sale of marketable securities or other assets, gifts of cash, or cash equivalents, and they must be verified as to their availability and liquidity. For partnerships and corporations, liquid assets owned jointly with other partnerships, corporations or individuals cannot be included.

7-7. LOAN ASSUMPTIONS

a. General Requirements. HUD's policy at this time is to permit assumptions of Section 312 Loans, provided that the new borrower meets all the eligibility and underwriting requirements included in this Chapter 7 of the Handbook. If a proposed assumptor seeks to assume an existing three percent (3%) Section 312 Loan, but does not meet the income requirements detailed in Paragraph 2-3-a, the assumption may be approved if the interest rate is adjusted to the date of approval of the assumption in accordance with Paragraph 2-3-b. If the existing borrower of a three percent (3%) Section 312 Loan is in danger of being foreclosed upon by HUD, or can provide

satisfactory evidence showing he/she is subject to imminent foreclosure by another lender, the Director of the HUD Headquarters Office of Urban Rehabilitation may waive the income requirements detailed in Section 2-3-a of this Handbook for a potential assumptor. HUD reserves the right to reject any proposed assumption, particularly in the early years of a Section 312 Loan, where it is found that the proposed assumptor had any expectation of assuming the loan prior to the origination of the Section 312 Loan.

b. Underwriting Procedures. All applications for assumptions must be forwarded to HUD's Master Servicer for a complete review, along with the LPA recommendation if available. LPA's are encouraged (although not required) to conduct all necessary verifications in accordance with Chapter 5, and underwriting in accordance with this Chapter 7 for all potential borrowers seeking to assume a Section 312 Loan. LPA's are also encouraged to make a recommendation as to whether (a) the new borrower is qualified for a Section 312 Loan, and (b) the assumption is consistent with local objectives. If the LPA does not conduct the required verifications, these must be done by the Master Servicer. The Master Servicer must then submit all assumption applications to the HUD Headquarters Office of Urban Rehabilitation for final approval. HUD Field Offices have no involvement in loan assumptions.

7-8. MAKING A FINAL DECISION ON THE LOAN. After all the underwriting factors have been considered, the LPA must evaluate all the data and decide whether the potential borrower is an acceptable risk in order to recommend approval of the loan to HUD, or for localities with Local Loan Approval Authority, to approve a single-family loan. (See Paragraph 7-4 of this Handbook for additional information on the role of the LPA, HUD Field Office and HUD Headquarters in underwriting and making a decision on Loans.)