Chapter 5. Processing Initial Notices of Intent (NOIs) to Extend Affordability Restrictions by Retention or Sale

5-1. Purpose. The purpose of this Chapter is to outline the steps Loan Management staff must take when it receives an Initial Notice of Intent to extend affordability by either retaining the project or selling it. It explains what Loan Management staff need to know about the Capital Needs Assessment and Appraisal process and explains how the information developed in these steps will be used.

5-2. Windfall Profits Test.

A. To prevent windfall profits to owners, the Department may make available incentives only to owners in those rental markets where there is an inadequate supply of decent, affordable housing or where it is necessary to accomplish the other public policy objectives. The preservation solution is not to be used to provide incentives to owners who would not have prepaid, given local market conditions. Therefore, this test is part of the criteria for determining a project's eligibility to receive incentives.

B. Consistent with the statutory requirements, the test will be carried out in three parts in a manner to encompass the concerns about affordability and adequacy of supply and other public policy objectives.

1. The Windfall Profits Test will be conducted in accordance with the Notice published in Federal Register 3177.

2. Immediately upon receiving an Initial NOI to extend affordability by retention or sale, Loan Management staff will forward the Initial NOI to the Economic and market Analysis Staff (EMAS) for review under the Windfall Profits Test LOG date sent .

3. If the Loan Management staff determines that the owner should be denied eligibility

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to apply for incentives because of the results of the Windfall Profits Test, the owner will be informed within 30 days of submitting an Initial NOI and the process under this Handbook will end. LOG end of process If Loan Management staff determines that the project is eligible to receive incentives, it will continue the process as described in the remainder of this Handbook.

5-3. Submission of the Initial Notice of Intent to Housing Programs Branch.

A. Concurrently with submission of the Initial NOI to EMAS, Loan Management staff will also forward three copies of the Initial NOI to the Housing Programs Branch, Attention: Architectural and Engineering (A & E) Branch and Valuation Branch. LOG date sent Loan Management staff must also provide the following information:

1. Last three years' physical inspection reports and owner's responses and clearance of findings from the Housing Management loan files;

2. Any correspondence relating to the condition of the project during the last three years;

3. Last three years of project financial statements;

4. As-built plans and specifications (if available);

5. Page 1 of Form HUD-92013, completed by Housing Management;

6. Expiration date of the current Section 8 contracts.

B. A & E will perform a Capital Needs Assessment in accordance with Housing Development's Processing Instructions for Implementing Title VI (Implementation Memorandum), but if unable to do

so, will arrange with the Regional Contracting Officer (RCO) to contract for a Capital Needs Assessment. Within 15 days of receipt of the Initial NOI, the RCO will contract for the Capital Needs Assessment, if applicable, and Housing Development staff will schedule the

Assessment and report the date to the Loan Management Branch. LOG receipt of date for inspection Please note that since a portion of the Capital Needs Assessment, in accordance with Paragraph 5-7, must be completed within 60 days of receipt of the initial NOI, Loan Management staff should not wait for the results of the Windfall Profits Test before scheduling the inspection. The inspection may have to be cancelled if the project does not pass the Windfall Profits Test.

C. Valuation staff will work with the RCO to contract for an appraisal of the project. The appraisal may have to be cancelled if the project does not pass the Windfall Profits Test.

5-4. Information to Owners Who Requested Incentives. Within 20 days of receipt of the Initial NOI to extend affordability restrictions, Loan Management staff will send the Letter to Owner Transmitting Appraisal Guidelines, Appendix 5-1, which contains the information the owner needs to proceed with the Capital Needs Assessment and appraisal process. LOG date sent The information explains:

A. The requirements for a Capital Needs Assessment that will be conducted by HUD or a HUD contractor as set forth in Paragraph 5-7 and the Implementation Memorandum. Loan Management staff will tell the owner the scheduled date for the Assessment, if known. Otherwise, the owner will be told that HUD will advise it later of the date and time for the Capital Needs Assessment physical inspection and exit conference.

B. The need for, and the rules and guidelines governing an appraisal of the project. All appraisals conducted on eligible low-income

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housing must comply with the "Guidelines for Determining Appraisals of Preservation Value Under the Low-Income Housing Preservation and Resident Homeownership Act of 1990" (Appraisal Guidelines). The owner is responsible for forwarding these guidelines to the appraiser it selects;

C. The filing deadline for submission of the appraisal which is four months from receipt of the initial NOI;

D. The need for an appraiser retained by HUD to appraise the project in accordance with the Appraisal Guidelines and inspect the project's financial records in order to make determinations required by Appendix 5-2, Form HUD-9607, Calculation of Information to be Returned to the Owner; and

E. That HUD will delegate to an appropriate State agency, if applicable, the responsibilities regarding the performance of an appraisal. This statement will be added to Appendix 5-1, if relevant.

5-5. Information to Tenants. By means of Appendix 5-1, the owner will be advised that it must post Notice to Tenants, Appendix 5-1A, which advises tenants of the project about the appraisal and the Capital Needs Assessment physical inspection and exit conference. This letter will give tenants and tenant representatives, if any, the right and opportunity:

A. To provide input into the Capital Needs Assessment up to the time of the exit conference for the inspection, the date of which will be posted at least two days prior to the inspection;

B. For tenant representatives to attend the physical inspection and all tenants to attend the exit conference, for which the date and time will be posted at least two days in advance;

C. To be provided further information by both HUD and the owner at various stages of the extension process and to be given further opportunity to comment; and

D. To obtain the name, address, and phone number of any tenant representative who has been provided this information and who will be expected to consult with, provide guidance to, and act on behalf of the tenants.

5-6. Information to State and Local Governments. Simultaneously with sending Appendix 5-1, Loan Management staff will make information about the Capital Needs Assessment and appraisal process available to State and local governments LOG date sent by sending them a copy of Appendix 5-1 and its attachment, Appendix 5-1A. By means of this letter, Loan Management staff will advise State and local governments that they have the right to provide input into the Capital Needs Assessment, including having local code enforcement officials participate in the physical inspection and exit conference, and to provide further input at various other stages of the decision-making process. Any information provided to the owner under this Chapter, subsequent to the appraisal, will also be provided to the State and local governments.

5-7. Capital Needs Assessment. The Capital Needs Assessment will be conducted in accordance with the Implementation Memorandum. LOG date of Assessment The Assessment will be conducted in two parts: the physical inspection and the exit conference. The exit conference will be held within one day of the physical inspection. At the exit conference, the contractor will discuss the findings of the physical inspection and obtain additional input from those in attendance. A & E Branch will provide Valuation and Loan Management Branches with the results of the first portion of the Capital Needs Assessment within 60 days of the Initial NOI. LOG date received The portion that must be forwarded, at this point, is the portion that refers to the repairs required to bring the property up to good condition, exclusive of HUD regulatory requirements, if not required by the local

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governing body. Valuation Branch will forward the results to HUD's appraiser and Loan Management staff will forward the results to the owner who must forward the information to its appraiser. LOG date sent to owner/appraiser The total Capital Needs Assessment need not be completed until 120 days after receipt of the Initial NOI. The results will be forwarded to the owner for its review at that time. LOG dates received and forwarded

Submission of Appraisals. Within four months of filing the Initial NOI, the owner must submit an appraisal, conducted by a qualified appraiser selected by the owner, to the Valuation Branch. LOG date appraisal received At the same time, Valuation Branch must receive an appraisal from an independent qualified appraiser contracted by HUD. LOG date appraisal received Both appraisals will conform to the instructions in the Appraisal Guidelines. Valuation Branch will forward a copy of HUD's appraisal to the owner. LOG date sent Each appraisal must show two appraised values, Extension Preservation Value (EPV) and Transfer Preservation Value (TPV), in accordance with Paragraphs A. and B. below. Neither appraisal may be more than 30 months old at the time of Plan of Action (POA) approval (unless POA approval was delayed by HUD for reasons beyond the owner's control). All appraisals must be updated if a new Initial NOI to extend affordability is filed for any reason.

A. Extension Preservation Value: Highest and Best Use as Residential Rental Property. The Appraisal Guidelines require that the appraiser assume the conversion of the project to market rate rental housing for determining the EPV. Other factors that must be taken into account in determining these values include:

1. The Amount of Required Repairs necessary to sustain the property to a good condition consistent with the Implementation Memorandum. A and E staff will determine the repairs that are required to bring the property up to good condition in addition to those required by HUD regulatory

requirements. Valuation Branch will provide this data to both appraisers. The appraiser will use the upgrading improvements in determining their costs and will reflect the required repairs and upgrades in the final estimate of the EPV.

2. Non-Rehabilitation Costs of converting to market rate rental housing. These would include the costs of conversion of a project occupied by subsidized tenants to one occupied by market rate tenants and the costs of advertising, turnover, vacancies, unpaid rents, evictions, etc.; and

3. Operating Expenses. Operating expenses used for the appraisal will be the greater of the following expenses which will be determined by the appraiser(s), subject to HUD's approval:

   a. Average operating expenses during the preceding three years or the operating expenses for the past year, depending on whether the last year's or the average of three year's operating expenses are a more realistic estimate of future expenses; or

b. Projected operating expenses after conversion.

B. Transfer Preservation Value: Highest and Best Use. The Appraisal Guidelines require that the appraiser assume conversion of the project to the highest and best use for the property. If the highest and best use is a market rate rental project, the value determination will be the same as in Paragraph A. If the highest and best use is as a condominium, cooperative, etc., the conversion costs will be handled in the same manner as in Paragraph A. If the highest and best use is for another use, the appraiser will determine the rehabilitation, conversion, demolition, and other costs associated with achieving the highest and best use of the

project. These costs must be reflected in the appraiser's final estimate of the TPV. Depending on what the highest and best use for the project is determined to be, the issues outlined in Paragraph A above should be addressed. Projected operating expenses after conversion must be used if the project is being appraised for purposes other than as rental housing.

5-9. Reconciliation of Appraisals.

A. Review of Appraisals. Upon receipt of the appraisals submitted by the owner and by HUD's appraiser, valuation Branch will review the appraisals for accuracy, sufficiency, and compliance with the Appraisal Guidelines. The Valuation Branch may consult with both appraisers, if necessary. The appraised values will be accepted if they meet the review requirements.

B. Determination of Values. Within 30 days of receipt of the appraisals, Valuation Branch will determine the two reconciled preservation values. LOG date of determination If necessary, Valuation staff will hold discussions with both appraisers and the owner in order to reconcile the differences. As a final recourse to achieve reconciliation, the owner may wish to accept an appraised value in accordance with the guidelines below.

1. The values determined by the owner's appraisal will be used in all cases where the values do not exceed 105 percent of the value in HUD's appraisal.

2. If either of the owner's appraised value(s) exceed 105 percent of HUD's comparable value, Valuation Branch will negotiate with both appraisers in an attempt to bring the two appraised values into the required range, giving them an opportunity to reconcile the differences.

3. If the appraisers cannot agree on a reconciled range which meets the criteria in Paragraph 2 above, the owner may agree to accept 105 percent of HUD's appraised value as the reconciled value, so that a third appraisal will not be required.

4. If either or both EPV or TPV cannot be reconciled in accordance with Paragraphs 1 through 3 above, a third appraisal must be conducted for either or both values, depending on which are not reconciled. The third appraisal will be conducted in accordance with Paragraph 5-10.

5-10. Third Appraisal. A third appraisal will be conducted if the owner wishes a third appraisal to establish a value for one or both unreconciled value(s). The owner should be advised of the timeframe for selecting the appraiser in accordance with Paragraph A. below.

A. The appraiser for the third appraisal must be selected by the end of six months from the date that the Initial NOI was filed (or one month from the date the owner requests a third appraisal), whichever is sooner. LOG date appraiser selected

B. Loan Management staff must send appraisal guidelines and the results of the Capital Needs Assessment to the third appraiser. However, Loan Management staff will not give information about the first two appraisals to the third appraiser.

C. The appraiser will be selected and contracted with by the owner from a list provided by HUD.

D. The owner will provide the appraiser the Appraisal Guidelines. The owner will be advised that it must not provide the appraiser with any information from the previous appraisals.

E. The appraiser must submit the third appraisal to the Valuation Branch within two months of

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accepting the assignment. LOG date received The owner must be sent a copy of the third appraisal for review LOG date sent

F. Third appraisal results will be binding subject to HUD and owner review for compliance with Appraisal Guidelines and regulations. This is true even if the value(s) determined is/are higher or lower than the value(s) in both previous appraisals.

G. Upon completion of an acceptable third appraisal, the owner submits a copy of the appraisal and an invoice for the full amount to the RCO. HUD will pay half the amount on the invoice.

5-11. Sending Information to Owners. Within nine months of receipt of the Initial NOI:

A. Valuation staff must complete its review and calculate the figures described in Paragraph 5-12.

B. Valuation staff must complete Form HUD-9607.

C. Loan Management staff must work with the Valuation Branch to complete Letter to Owner Transmitting Information for Extending of Affordability Restrictions Through Retention or Sale, Appendix 5-3.

D. Loan Management staff must send Form HUD-9607 and Appendix 5-3 to the owner, along with Appendices 5-3A, and 5-3B, which address repairs and sales and 5-3C, the Notice to Tenants. LOG date sent The letter instructs the owner to post this information at all affected buildings.

5-12. Calculating Figures from Appraisal Data. Valuation Branch will calculate the following figures from the appraisal data, working jointly with Loan Management staff when necessary. The owner will use this information to determine whether to retain or sell the project.

A. Preservation Values. See Sections I and II on Form HUD-9607.

B. Preservation Equity. See Sections III and IV on Form HUD-9607.

C. Annual Authorized Return to Owner. (See Section V on Form HUD-9607.) Restrictions on its receipt will be in accordance with Chapter 8 Reserved .

D. Federal Cost Limit. See Section VI on Form HUD-9607 for the market area (or relevant local market, if applicable) in which the project is located. The Federal Cost Limit (FCL) does not represent the unit rents that will actually be charged at the project after the incentives are granted or any transfer takes place. It does represent the maximum rent that may be supported by incentives. The limit is the same for any one project whether the owner chooses retention or transfer.

E. The Aggregate Preservation Rents. See Sections VII and VIII on Form HUD-9607 for the project are the total annual gross rents needed by the project to pay specific costs. These rents will be used solely for the purposes of comparison against the FCL and will not necessarily reflect the final rents that will be needed to operate the project. Two preservation rents will be calculated:

1. Extension Preservation Rent. The extension preservation rent (EPR) is the gross potential annual income for the project, as determined by HUD, which would be required to support:

a. The annual authorized return on equity used as an incentive for the current owner to maintain affordability over and above any amount needed to support debt service coverage for the underlying mortgage and any rehabilitation loans on the project;

b. Debt Service, including debt service coverage, on any rehabilitation loan which the Capital Needs Assessment has determined necessary, in accordance with the Implementation Memorandum. This calculation must take into account:

i. That any grants for rehabilitation anticipated to be provided by State or Local Governments have been deducted from the amount of any loan required;

ii. The assumption that the loan has a market rate of interest and a 20-year amortization period;

iii. The assumption that only 90 percent of rehabilitation costs may be provided by a loan; and

iv. That the rehabilitation requirements and projected costs which the Capital Needs Assessment determines for this purpose do not necessarily reflect the final rehabilitation requirements and/or costs when the incentives are granted.

c. Debt Service, including debt service coverage, on the federally-assisted mortgage for the project;

d. Project operating expenses as determined by a consultation between the Valuation Branch and Loan Management staff. NOTE: Any expense that is paid by the tenants (Personal Benefit Expense) must be included in the project expense estimate . These expenses will assume that all required repairs have been completed;

e. Adequate reserves, as determined by Valuation, based on the Capital Needs Assessment. The amount of reserve deposits used will be the amount which, when added to existing reserves, are sufficient to maintain the project after required repairs have been made to bring the project to Housing Quality Standards; and

f. Three percent vacancy allowance.

2. Transfer Preservation Rent. The transfer preservation rent (TPR) is the gross potential annual income for the project, as determined by HUD, which would be required to support:

a. Debt Service, including debt service coverage, on a loan for acquisition, which may not exceed 95 percent of Transfer Preservation Equity, and the requirements set forth in Chapter 8 Reserved ;

b. Debt Service, including debt service coverage, on any rehabilitation loan which the Capital Needs Assessment has determined necessary, in accordance with the Implementation Memorandum. This calculation must take into account:

i. That any grants for rehabilitation anticipated to be provided by State or Local Governments have been deducted from the amount of any loan required;

ii. The assumption that the loan has a market rate of interest and a 20-year amortization period;

iii. The assumption that only 90 percent of rehabilitation costs may be provided by a loan; and

iv. That the rehabilitation

requirements and projected costs which the Capital Needs Assessment determines for this purpose do not necessarily reflect the final rehabilitation requirements and/or costs when the incentives are granted.

c. Debt Service, including debt service coverage, on the federally-assisted mortgage for the project;

d. Project operating expenses as determined by the Valuation Branch in consultation with the Loan Management staff. NOTE: Any expense that is paid by the tenants (Personal Benefit Expense) must be included in the project expense estimate. These expenses will assume that all required repairs have been completed;

e. Adequate reserves, as determined by Valuation, based on the Capital Needs Assessment. The amount of reserve deposits used will be the amount which, when added to existing reserves, are sufficient to maintain the project after required repairs have been made to bring the project to Housing Quality Standards; and

f. Three percent vacancy allowance.

F. Comparison of Preservation Rents and Federal Cost Limit.

1. Owner's Options. (See Section IX on Form HUD-9607.) Both EPR and TPR are compared to the FCL to determine the owner's options when submitting a POA. These options are

explained to the owner, along with a summary of the above factors, in Appendix 5-3. They are also described in Chapter 6.

2. Transfer Preservation Rent Exceeds the Federal Cost Limit. (See X on Form HUD-9607.) In order to help owners make an informed choice of available options, in all cases where TPR exceeds the FCL, Loan

Management Branch will determine the maximum acquisition loan which would bring the TPR down to the FCL. The maximum sales price which can be supported by this acquisition loan, based on current rates and terms, may be provided to the owner.