CHAPTER 7. REHABILITATION

7-1. GENERAL. This Chapter established procedures and policies for processing applications for rehabilitation under the Section 236 and Rent Supplement programs. Many of these basic procedures and policies may also be applied to multifamily rehabilitation under other HUD-FHA multifamily programs.

a. Within the framework of these policies and procedures, HUD-FHA field offices are expected to stimulate and assist rehabilitation efforts.

b. The policies and procedures set forth in this Chapter represent important departures from former HUD-FHA practice in the processing of applications for multifamily rehabilitation. They are based on experience gained in rehabilitation experiments and demonstrations carried out in various cities and are designed to provide a method for processing rehabilitation applications realistically and quickly. The more important departures from past policy and procedures are:

(1) There is to be a joint inspection of the proposed property and an extensive pre-application feasibility review in which HUD-FHA works with the sponsor to establish whether the proposed rehabilitation can, in terns of acquisition and rehabilitation costs, successfully meet standards and be priced within the rent paying ability of the anticipated residents.

(2) Location alone is no longer sufficient cause for the denial of HUD-FHA programs to inner-city areas. The programs, particularily rehabilitation, must be made available where the need is most acute. HUD's project selection criteria do not apply to rehabilitation proposals.

(3) A reasonable reserve for contingencies, including unexpected increases in rehabilitation costs, is to be used in establishing feasibility and is to be included in the amount of the mortgage commitment.

7-2. CRITERIA FOR ACCEPTANCE OF REHABILITATION PROPOSALS. The test of the acceptability of an application is the soundness of the proposed rehabilitation project, the promise it holds for sustaining the physical and social upgrading proposed to be achieved, and the reasonableness of the risks inherent in the transaction in light of the important social objectives to be achieved.

a. Among the Questions to be Answered when judging the acceptability of a rehabilitation proposal are:

(1) Is the structure suitable for rehabilitation to a reasonable standard of livability and safety and can this be accomplished without producing rent levels beyond capacity to pay?

(2) Can the quality of housing for the present residents of the the neighborhood be improved with a minimum of displacement?

(3) Is the proposed rehabilitation project of sufficient size to give reasonable promise that the upgrading will be sustained? The necessary size varies in different circumstances. In relatively sound, older neighborhoods, rehabilitation of a few properties or a single multifamily structure may be acceptable. In more blighted older neighborhoods, the size and impact of the proposed rehabilitation may need to be larger if it is to give reasonable promise of sustained and self-reinforcing upgrading. Consideration should be given to the possibility of generating additional rehabilitation projects in the immediate area as a means of spreading and reinforcing the revival of the neighborhood. It is not necessary that all properties within the project be contiguous, but they should be sufficiently numerous and sufficiently close together to make a positive visual impact on the neighborhood.

(4) Does the sponsor have the capacity to provide financially sound, sympathetic, socially-oriented sponsorship of the project?

(7-2) (5) Can the sponsor communicate effectively with the residents of the neighborhood to gain their understanding, cooperation, and support (of course, a sponsor may also cause these things to be done by a competent public or private agency or neighborhood organization)? The success of rehabilitation in older, blighted areas is less dependent on the physical improvements than on the attitudes, habits and responsiveness of the residents, and the quality of management provided. It is essential to investigate these matters. It may be necessary for affected residents to be given homemaker training and other counseling and consumer protection assistance. These may be funded through HUD, HEW, and other public or private organizations. The important thing is to determine that there is a realistic plan for providing the required management and human services.

(6) Are open space and public facilities adequate? Successful rehabilitation in older areas may require increased open space, street improvements, traffic rerouting, removal of substandard alley dwellings and other factors contributing to blight and overcrowding, and provision of other public improvements. It also may require a commitment by the city to enforce housing and health codes, or to waive certain provisions of the building code. When these things are needed to give a rehabilitation project reasonable promise of success, the Field Office Director must see that arrangements are made for their provision by the sponsor or some other public or private agency.

(7) Are relocation requirements adequately provided for? The main objective of rehabilitation is to improve not only a neighborhood but also to improve the housing conditions of the families now living in the neighborhood at rents within their paying capacity. Therefore, the sponsor, perhaps with the assistance of a public or private agency, is required to develop a satisfactory plan for phasing the rehabilitation and arranging for temporary relocation of families in a manner calculated to (a) maximize the number of resident families who are rehoused in the same projects and (b) minimize displacement. This plan must also include steps for dealing satisfactorily with any permanent family displacement which is unavoidable.

(8) Is the proposal reasonable and acceptable in terms of operating costs? With proper management of the project, it should be able to operate successfully during the initial years without an immediate need for a rent increase.

(9) Had the sponsor proposed a management plan and a management firm acceptable to the Director of the office? The Management Division should review the management plan and decide whether the management firm is capable of

handling a multifamily rehabilitation project. This should be done during the time feasibility is being determined.

b. The Above Criteria are primarily intended to evaluate the acceptability of a multifamily rehabilitation proposal in an older section of the city outside an urban renewal, code enforcement area, or model cities neighborhood. For multifamily rehabilitation proposals inside urban renewal, or code enforcement areas, HUD-FHA assumes that these programs provide the conditions and actions necessary to assure the acceptability of the proposal.

7-3. LOCATION.

a. In Reviewing Applications under the Section 236 and rent supplement programs, no neighborhood is to be excluded solely because of economic or social conditions.

b. The Objective of These Programs, as in many other HUD-FHA programs, is to provide the assistance of insured mortgage financing and to put the thrust of federal assistance behind the renewal and revitalization of older neighborhoods.

c. Rent Supplement Projects must be located in an area having a Workable Program or the project must receive official local approval.

d. Section 236 Projects do not require a Workable Program or specific approval of the local government body unless some of the occupants will receive rent supplement assistance.

e. The Total Number of Units Receiving Assistance under (1) the rent supplement program, (2) Public Housing Section 23, (3) Section 10(c) leasing, or (4) any combination of the three, may not exceed 20% of the total units in a Section 236 project. Waiver of this administrative limitation may be requested from Central Office, Director, Subsidized Housing Programs.

7-4. TERM OF LOAN.

a. The Basic Factor to be Considered in establishing the term of a multifamily rehabilitation mortgage is the need to establish a term sufficiently long to keep rents within the paying capacity of the present residents of the neighborhood consistent with a degree of risk which is reasonable in the light of the important social objectives to be achieved.

b. From a Maximum of 40 Years, the mortgage term may be adjusted downward as circumstances and considerations of feasibility require. The use of a particular mortgage term reflects expectation concerning whether:

(1) The property will be properly maintained;

(2) There will be a continuing demand for reasonably priced housing;

(3) Federal and local programs to arrest urban decay will be successful;

(4) Inflation will continue and tend to offset partially the usually-assumed straight line depreciation; and

(5) The property, given adequate maintenance, will have a physical life which will exceed the mortgage term.

c. If the Possibility Exists that the present residential uses of the land will be terminated before the term of the mortgage expires, consideration should be given, in setting the term of the mortgage, to the likelihood that the underlying land will increase in value by virture of being put to a "higher and better" use. In such case, an amount equal to any then outstanding mortgage debt could be recovered. Inner-city land has the potential of increasing in value.

d. Use of the Above Approach in establishing the "term of loan" means that an estimate of economic life will not be made.

7-5. DESIGN GUIDELINES.

a. Technical Advances and Design Innovations. Because of the difficulty of establishing realistic and practical levels of rehabilitation, HUD-FHA personnel must use imagination and flexibility, as well as sound judgment, in applying guidelines contained in Reference (20) of the Foreword. Use should be made of technical advances and design innovations that offer promise of cost savings and improved living for residents (see Chapter 9 with regard to rehabilitation of housing for the elderly and handicapped).

b. The Type of Neighborhood Involved in the rehabilitation will influence which one of the following sets of standards apply to a particular project:

(1) For multifamily rehabilitation projects proposed in approved urban renewal areas, the applicable minimum property standards are the Property Rehabilitation Standards prepared for the area (after consultation with HUD-FHA and based on Reference (20) of the Foreword) and included as part of the Urban Renewal Plan approved by HUD-FHA for the specific area.

(2) For multifamily rehabilitation projects proposed in approved Section 117 Code Enforcement Areas, the applicable minimum property standards are the Comprehensive System of Codes established for the area (after consultation with HUD-FHA and based on Reference (20) of the Foreword) and included as part of the Local Code Enforcement Program approved by HUD.

(3) For multifamily rehabilitation projects proposed in older, inner-city neighborhoods, but outside of approved Urban Renewal and Code Enforcement Areas, the objectives, standards, and requirements of Reference (20) of the Foreword provide the design and construction guidelines for rehabilitation.

7-6. CONTINGENCY RESERVE. To provide for unanticipated costs, difficult to estimate in the rehabilitation of older structures, there will normally be included in the mortgage amount a reserve for contingencies. This reserve is based upon the percentage of estimated rehabilitation cost without fees (the sum of lines 36C, 41 and 42 of Part G, FHA Form 2264). It may range from 0 to 10%

depending upon job conditions and the experience and financial ability of the sponsor, the mortgagor and the contractor. With inexperienced nonprofit sponsors, a 10% reserve may be required. In deciding on the amount of the contingency reserve, consideration must be given to whether the contractor's bid already contains an adequate reserve for contingencies. The contingency percentage is included as a separate item in the estimate and is to be
* entered on line 70, Part G of FHA Form 2264. *

a. The reserve may be used, when necessary, to cover unforeseen costs of construction, unanticipated financing costs occasioned by unavoidable delays in construction, and similar items. The reserve may not be used to provide additional profit or fees to the architect, attorney, or other principals. The reserve may not be utilized to defray the expense of unwarranted or luxury items caused by changes in construction or substitution of materials or equipment.

b. The contingency reserve is included in the mortgage amount, and its disbursement is controlled by the Finance and Mortgage Credit Section as shown on FHA Form 2451 (Financial Record of Mortgage Loan Transaction). No advance from the reserve may be made by the mortgagee prior to and without the advance written consent of the Field Office Director. At closing, the mortgage is to be reduced as necessary by the unused amount of the contingency reserve, as reflected by certification of actual costs. However, if the acquisition cost of
* the property exceeds the FHA finding of "as is" value by a residual approach, any portion of the contingency reserve not used as cost certification may, in lieu of reducing the mortgage amount, be applied to the purchase of the property. The amount of unused reserve funds so applied plus the residual "as is" value may in no case exceed the actual purchase price of the property or the fair market "as is" value, whichever is lower. *

7-7. EVALUATION OF PROPOSALS.

a. Coordination Between HUD-FHA and the Sponsor. Successful production of low- and moderate-income rehabilitation proposals will depend, in part, on the development of a close, positive working relationship between HUD-FHA staff and the project sponsor and his architect and contractor, especially in assembling data and carrying out inspections required to

(7-7) establish the feasibility of a proposal. Once feasibility is established, HUD-FHA must provide the sponsor all possible assistance, support, and guidance in developing an acceptable application and a successful project in the shortest time possible.

b. Screening of Properties. Prior to submitting properties for feasibility review, the sponsor should accomplish the following with appropriate guidance from the field office:

(1) Identify any code violations filed against the properties, determine whether city activities are planned which could affect or be affected by the use of the buildings after rehabilitation, and relate the project to present or proposed urban renewal plans.

(2) Make a preliminary judgement on the physical and economic feasibility of the proposed rehabilitation in light of the physical condition of the structures, the extent of

rehabilitation which seems appropriate, tentative per unit cost estimates of the work, and the relationship between the rent paying ability of the intended market and the estimated mortgage amount.

(3) If, after screening the properties, the sponsor decides to proceed, the Field Office Director should be notified by submission of a preliminary FHA Form 2013-R and a statement of the conclusions of his evaluation, the location of the properties, and the information outlined above. A financial statement, or other evidence of financial capacity to undertake the proposed project should also be submitted at this time.

(4) If appropriate, FHA Form 3433 (Request for Preliminary Determination of Eligibility as Nonprofit Sponsor or Mortgagor) and FHA Form 2530 (Previous Multifamily Participation Certificate) should be submitted.

c. Preliminary Joint Inspection of Properties. Upon receipt of the sponsor's preliminary FHA Form 2013-R, the Field Office Director is to schedule a joint inspection of the properties at the earliest possible date. The inspection team will include an appraiser and architect, the sponsor and the sponsor's architect and contractor (if selected). A representative of the local building inspector's office should be present, if available.

(7-7) (1) This joint inspection team will analyze the following elements:

(a) The physical condition of the buildings, including the existence of major structural defects and signs of advanced deterioration or obsolescence.

(b) Whether the character of the neighborhood justifies the property values to be created by rehabilitation.

(c) The extent and nature of work needed to attain the level of rehabilitation considered appropriate to the rent paying capacity of the prospective tenants, project operating costs, and continued marketability of the project.

(d) The economics of demolition weighed against the cost of rehabilitation. The feasibility of rehabilitation should be tested by comparing its cost with new construction whenever there is question as to whether building a new structure would be more practical. Where appropriate, a project mortgage may cover the rehabilitation of units worth saving and the construction of new units to replace those which cannot be rehabilitated economically. Cost estimates of comparable new construction may be based on comparative square foot data.

(2) Subsequent to completion of the joint inspection, the Field Office Director is to confirm, in writing to the sponsor, the decisions reached and outline in broad terms the degree and nature of rehabilitation necessary to make the project acceptable.

(3) Generally, the exhibits identifying this work should be limited to those essential for processing. Information obtained by the sponsor from his screening activities is usually sufficient. However, physical re-arrangement or structural changes may require a sketch plan showing existing conditions and proposed work.

d. Feasibility Determination. The sponsor will submit a tentative per unit rehabilitation cost estimate based on agreements reached at the joint inspection.

(7-7) (1) HUD-FHA will estimate rents for which there is a market at income levels characteristic of the neighborhood. Rents for Section 236 projects will not exceed the fair market rents for similar properties. In order to reach as broad a market of eligible tenants as possible, sponsors should be discouraged from building at the maximum supportable costs. Otherwise, the number of eligible families may be so restricted as to endanger the soundness of the project. Economies should be sought in design, construction and operation.

(2) If the sponsor is eligible, estimates are reasonable, and if appropriate mortgage amount and term can be supported by projected rental income, the sponsor will be advised by letter that the project is feasible. A feasibility conference may be scheduled at this point if necessary or desirable. The sponsor will be requested to furnish any exhibits needed for further processing.

e. Joint Work Write-up.

(1) Subsequent to receiving the sponsor's letter of intent to submit an application, the Director will schedule a second joint inspection of the properties. Based on this inspection, field office personnel and the sponsor will prepare a detailed statement of the rehabilitation work to be done. Conclusions made at this point concerning the nature and extent of the work will form the basis for the sponsor's formal application, HUD-FHA commitment conditions, and the required closing exhibits.

(2) Coordination of individual underwriting functions into a simultaneous processing effort is essential during preparation of this comprehensive work write-up because agreement must be reached by the examination team concerning the nature and extent of each item of work to be required, the exhibits necessary to describe such work, the estimated rehabilitation cost, the overall economic feasibility of the project, the tentative mortgage amount and term, the estimate of interest during the construction period, and the contingency allowance to be included in the total cost estimate.

(7-7) (3) For rehabilitation projects which consist of a number of similar buildings and conditions, the chief architect may determine that, because of similarity, the work write-ups made for a representative number of typical buildings or living units will constitute the basis for estimating construction costs for the entire project. Sound judgment must be exercised to assure that the buildings or living units selected are representative of those included in the project. This procedure should be used to the extent feasible to reduce manhours involved in making the work write-ups and in estimating costs.

(4) The narrative portion of the work write-up is divided into two parts:

(a) General Requirements. Includes rehabilitation work applicable to all elements in the project; for example: site work; exterior work; painting and decorating; rehabilitation of kitchens, bathroom, roofs, mechanical systems, electrical systems, interior walls, floors, windows, and doors.

(b) Special Requirements. Describes any special rehabilitation work required for a specific item, room, space, or building which is not required for the project as a whole. For example, the General Requirements may state that all floors are to be sanded and refinished. However, if in a particular living room the floor must be removed and replaced, this should be included in a Special Requirement for that particular room.

(5) During the work write-up, the team must keep in mind a balance between the physical characteristics of the properties and the financial aspects of the proposal. The objective is to achieve an attractive and acceptable property within the limit of funds available.

f. Exhibits. Because the nature and extent of rehabilitation may vary widely among individual projects, the particular exhibits needed for each case cannot be definitely identified until after the joint examination and write-up. Elaborate plans are not required but exhibits should be in sufficient detail to permit a complete review of the sponsor's proposal by HUD-FHA staff.

Generally, the following should suffice:

(1) A plot plan or site plan showing the location of building(s), parking and recreation areas, walks, drives, streets, and other relevant details.

(2) Sketch plans showing proposed work and existing arrangement in cases where structural or planning changes are contemplated. If the work can be adequately described in the specifications, no plans are needed.

(3) Specifications based on the comprehensive work write-up establishing the level of quality for workmanship and materials which will be acceptable for the project. This may be in the format of the Uniform System of Construction Specifications in which the items of work are described under the appropriate division headings or the specification may take the form of a series of separate work items. HUD-FHA Supplementary General Conditions must be included in each specification.

(4) The contractor's cost estimates based on the contract exhibits (plans/specifications) may be prepared in the format usually employed in the locality, or organized according to the division headings of the Uniform System of Construction Specifications. The format must be

conducive to rapid review.

7-8. UNDERWRITING REVIEW AND FINAL DETERMINATION. When the exhibits are prepared in accordance with these instructions, they are to be presented to the field office for review and final determination. HUD-FHA will review the exhibits for conformity with agreements previously reached and will check the cost estimates or firm bids for reasonableness. HUD-FHA will then prepare an FHA Form 2264 with estimates of rents, operating expenses, mortgage amount, cost of rehabilitation, contingency allowance, legal and organization costs, carrying charges, financing fees, the "as is" value of the property, and other appropriate items.

a. The Residual "As Is" Value is no longer the only estimate made for determining the Assistant Secretary-FHA Commissioner's estimate of "as is" value. Rather, "as is" value will be the lesser of Fair Market "As Is" Value or Residual "As Is" Value.

(7-8) b. The Fair Market "As Is" Value, reached by market comparison techniques, will be based upon the current market prices paid or asked for comparable properties in similar condition to the property being appraised. Thus, if comparable properties in similar condition are available for $4,000 per unit, justification for a value "as is" in any amount substantially in excess of $4,000 per unit is improbable.

c. Processing - Property to be Acquired. The "As Is" value and the Total Estimated Cost of Project (Items 70 and 71, Section G of FHA Form 2264) will be completed as follows:

(1) An appraisal of the project "as is" will be made on a supplemental FHA Form 2264 titled, Fair Market "As Is" Value using Sections A, B, C, D, E, F, I, J (Items 12 and 13 only) K and L (excluding the summation estimate).

(2) Use the applicable Replacement Cost Format (see Reference (16) of the Foreword) to find the total estimated project cost. Use the Market "As Is" Value from Step (1) above and the rehabilitation cost received from the cost analyst.

(3) Find the maximum supportable cost of the project after rehabilitation. The maximum supportable cost will be the lesser of;

(a) That cost indicated by working the "basic rent" portion of the Section 236 Rent Formula backwards starting with the Residential Basic Monthly Rent (as indicated by the rent limits) and working up to replacement cost: and

(b) The estimated cost of new production of similar units in this location.

(4) If the total estimated project cost from Step (2) above does not exceed the maximum supportable cost from Step (3) above, the Residual "As Is" value of the project will equal the Market "As Is" value from Step (1) above.

(5) If the total estimated project cost from Step (2) above is greater than the maximum supportable cost from Step (3) above, the "as is" value by the residual approach will be lower than the market "as is" value. Complete the Residual As Is Value Format" for property to be acquired (see Reference (16) of the Foreword).

(7-8) d. Processing - Property Owned. Where the project has been owned by the sponsor in excess of one year, the "As is" value will be determined in the same manner as for a property to be acquired. Since existing indebtedness is used in the interest calculation in place of the "as is" value for properties owned, this requires the use of a special format in Step (3)(e) titled, "Residual As Is Value - By Formula - Rehabilitation Projects (Property Owned)" if a residual approach is required (see Reference (16) of the Foreword).

(1) In any case, once the "as is" value has been determined by procedures described in paragraph 7-8.c. above, a check must be made to determine whether existing indebtedness will limit the mortgage. Where the maximum loan ratio is 90%, the procedure is as follows:

(a) Subtract the existing indebtedness from the "As Is" Value. The result is the sponsor's equity.

(b) If the sponsor's equity exceeds 10% of the lesser of the total estimated cost from Step c.(2) above or from the maximum supportable cost (or value) of the project from Step c.(3) above, the project mortgage will be determined by completing "Maximum Mortgage - By Formula - Rehabilitation Projects - Property Owned - When Existing Indebtedness Controls." Select the applicable format for projects with BSPRA (Appendix 5) and those without BSPRA

(Reference (16) of the Foreword).

1 Complete Section G of FHA Form 2264 based on the mortgage indicated using the "as is" value in Line G-70.

2 The existing indebtedness, although limiting the mortgage, is not to be entered in Line G-70.

(c) If the sponsor's equity is less than 10% as determined in Step d.(1)(b) above, the project mortgage will be 90% of the lower of the estimates in Steps c.(2) or c.(3) above. In this case, the format for "Maximum Mortgage - By Formula" is unnecessary and would produce an incorrect answer.

(2) If the maximum loan ratio is 100%, the basis for determining the mortgage controlling criteria is simply whether the sponsor has any equity. If so, the mortgage amount is to be determined by completing the format as in Step d.(1)(b) above. If the sponsor has no equity, the mortgage will be 100% of the lower of total estimated cost from Step c.(2) above or maximum supportable cost from Step c.(3) above.

(3) When part of the property has been owned by the sponsor for more than 12 months and part is to be acquired, the parts are to be processed as though they were separate projects. Thereafter, project cost, rents, expenses, and other items from the separate parts are to be added together to obtain figures for the composite FHA Forms 2264 and 2264A required to validate the single mortgage transaction.

e. Changes in Net Income and Estimated Cost. Several changes in the net income and estimated cost may occur as details of the proposals are developed during pre-commitment processing. The residual "as is" value is particularly sensitive to changes affecting cost or net income and should remain tentative until cost details of the proposed rehabilitation become reasonably firm. Some revision of estimates may be necessary to reflect changed circumstances, but this should be done with prudence.

f. The Estimate of Interest During the Construction Period shall take into consideration the interest charges associated with the acquisition of the property and the period of time for relocation activity.

7-9. APPLICATION FOR MORTGAGE INSURANCE. If the results of the HUD-FHA detailed underwriting review of the work write-up and exhibits are satisfactory, the Field Office Director will notify the sponsor, in writing, of the tentative mortgage amount and mortgage term, and will advise the sponsor that a formal application for mortgage insurance (on FHA Form 2013-R with fee) will be accepted.

7-10. COMMITMENT TO INSURE. Upon receipt, the sponsor's application (with fee, documents, and exhibits) will receive final HUD-FHA review to assure that all agreements and conclusions reached during pre-commitment processing are accurately portrayed. Since this submission provides the basis for the commitment and closing

(7-10) documents, any errors, omissions, ambiguities, or other non-conformities must be corrected. If the application is consistent with previous feasibility determinations, HUD-FHA will issue a formal commitment to insure which, in the context of applicable FHA regulations, embodies the conditions and requirements of the contract for mortgage insurance.