

CHAPTER 4. TECHNICAL PROCESSING

SECTION 1 - ARCHITECTURAL ANALYSIS AND INSPECTION

- 4-1. GENERAL. Follow basic instructions in Handbook 4460.1 REV., Architectural Analysis and Inspections for Project Mortgage Insurance, except as modified here.
- 4-2. RESIDENTIAL ACCOMMODATIONS.
- A. SRO projects are multifamily projects consisting of five or more SRO units.
- B. SRO projects must be comprised of one room units, except:
1. In substantial rehabilitation cases: a limited number of units larger than one room can be included if the Field Office determines that the cost of converting such units to single room units is excessive. The maximum number of units larger than one room shall not exceed 5 percent of the total number of units in a project, excluding nonrevenue producing units.
 2. Where a unit is proposed for occupancy by project staff, a nonrevenue producing unit(s) can be included for use by project staff. Nonrevenue unit(s), if provided, may have more than one room and a kitchen and bathroom. The Field Office Development Director in conjunction with the Field Office Housing Management Director shall determine the maximum number of nonrevenue units that are necessary for a project's successful operation.
 3. The construction analyst must assure that units containing more square foot area than that required to accommodate the maximum number of occupants permitted by the local government be divided into two or more units.
 4. A enclosed kitchen shall be considered a separate room; a bathroom shall not be considered a room, even when enclosed.

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- C. The minimum net floor area of a SRO unit will be as provided by local codes. In the absence of a local code governing the minimum space per person, the SRO

project owner will establish the minimum unit size, subject to approval by the HUD Field Office.

- D. SRO units may or may not have kitchenette and bathing facilities.

4-3. DESIGN CONSIDERATIONS.

- A. The Design Representative shall assure that suitable amenities are provided for the proposed tenants.
- B. Minimum design features which shall be included in each SRO unit:
 - 1. Refrigerator.
 - 2. Sink
 - 3. Storage space for food and utensils.
 - 4. Storage space for clothing (closet).
- C. Minimum design features which may be included in each SRO unit:
 - 1. Two burner range and oven or microwave oven.
 - 2. Garbage disposal.
 - 3. Toilet with privacy screening. A separate private toilet space is acceptable.
- D. An additional minimum design feature which must be included in each SRO unit if a common use bathing facility is not provided, is a tub or shower.
- E. Common use (shared) bathing facilities which must be provided if a tub or shower is not included in SRO units. Provide a separate facility(ies) for men and women, and a minimum total ratio of one tub or shower for every four tenants (1:4).

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- F. Common use (shared) kitchen facilities, if provided, shall meet the requirements of G (1) below and must be of a nonluxurious (modest) design. A common use (shared) kitchen may contain a sink and range or stove. It should be located in a area such as a multipurpose room which is designed to serve more than one purpose. Maintenance and security of common use facilities must be part of the owner's overall management plan.

G. Facilities and features which may be provided:

1. Special spaces such as multipurpose rooms, lobbies, lounges, common use (shared) kitchens, vending machine areas, and laundry; when provided, shall not exceed 5 percent of the project's total net floor area.
2. Suitable outside areas for active and passive recreational activities. Active recreational activity areas (e.g., basketball, handball, etc.) are those which require energetic action of participants. Passive activity areas (e.g., sitting, garden, etc.) require little or no action. Swimming pools are not permitted.
3. Aggregate commercial space floor area not to exceed 10 percent of gross building floor area except in substantial rehabilitation projects. Commercial space in substantial rehabilitation projects may be 20 percent of the gross building floor area. Commercial space above these maximums requires Headquarters approval.
4. Security (e.g., visual monitoring system, looking and self closing devices, metal detection, watch-person) to assure the safety of tenants and property.
5. Lockers for storage purposes.
6. Management and maintenance space.

- H. The cost of public telephones and exterior telephone wiring are not eligible to be included in replacement cost. The cost of interior (within building perimeter walls) wiring is eligible.

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- I. Utilities: Projects shall have master metering for all utilities.

4-4. STANDARDS.

- A. GENERAL. SRO projects shall conform to the requirements of HUD Handbook 4910.1, Minimum Property Standards for Housing. Where local codes and ordinances are more stringent than the requirements under HUD Handbook 4910.1, the local requirements shall prevail.

- B. ACCESSIBILITY. Covered multifamily dwellings of SRO projects are subject to the Design and Construction Requirements (24 CFR 100.205.) of the Fair Housing Amendments Act of 1988.
- C. Priority and Interpretation of Referenced Standards.
 - 1. This Charter's specific requirements must be met for the identified conditions, even if exempted by local standards.
 - 2. The Field Office is responsible for interpreting and enforcing HUD accepted codes and standards for the Department's purpose.
 - 3. HUD is not responsible for enforcing State, local and model codes.

SECTION 2 - COST ANALYSIS

- 4-5. GENERAL. Follow basic instructions in Handbook 4450.1, REV-1, Cost Estimation for Project Mortgage Insurance, except as modified here.
- 4-6. Initial Cost Estimate. Field Offices that do not have a SRO project in the data bank suitable to be used as a comparable for estimating proposed projects, must:
 - A. For each initial proposed project type (i.e., detached, semi-detached, row, two-story walk-up etc.) of wood, frame, masonry, concrete, etc., structural system, do the following:
 - 1. Make a quantity take-off of all building components from preliminary (conditional stage) or final drawings (firm stage) and categorize each trade item using the numerical coding system.
 - 2. Use applicable bench marks from data bank costs, commercial building cost data (Means, Dodge, etc.), and quotations from field sources to estimate the cost of each trade division by multiplying each item by the appropriate bench mark.
 - 3. Prepare Form FHA 2326, Project Cost Estimate, in accordance with outstanding instructions.
 - B. Record data from accepted Form FHA 2328, Contractor's and/or Mortgagor's Cost Breakdown, cost certifications, and conventionally financed projects.

4-7. PROJECT PROCESSING.

- A. Conditional Commitment. Make separate cost estimates of acceptable major movable furniture and equipment (items eligible and ineligible to be included in replacement cost). For projects involving rehabilitation, the sponsor must include any existing items with the item's age, useful life, and cost to replace. Estimate as lump sums from bench mark data of prior projects (202 projects until SRO data is established), per location and per SRO unit.
- B. Firm Commitment. Make separate cost estimates of acceptable major movable furniture and equipment lists (eligible and ineligible to be included in replacement cost). For projects involving rehabilitation,

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- (4-7) the sponsor must include any existing items with the item's age, useful life, and cost to replace.
 - 1. Check items of each list for acceptability.
 - 2. Estimate cost of acceptable items, including delivery and placement, but no fees (i.e., general requirements, builder's overhead and profit, etc.) of any kind may be included in the estimate. Accept Sponsor's estimates if reasonable.
 - 3. Enter the cost of both HUD estimates of major movable items on Form HUD-92264 under Section O, Remarks and Conclusions, and attach copy of accepted or modified lists.
- C. Cost Not Attributable to Dwelling Use. Include cost of major movable items eligible to be included in replacement cost as a separate item under the category "other."

4-8. PROPERTY INSURANCE SCHEDULE. Enter the cost of major movable items which are eligible to be included in replacement cost as a separate category on Form HUD-92329.

- A. Use HUD estimate after firm commitment.
- B. Use allowed cost after cost certification.
- C. Include in total 100 Percent Insurable Value.

4-9. COST CERTIFICATION REVIEW. The Sponsor submits a list of major movables installed (items included in replacement cost only) and the actual cost of each item as part of sponsor's cost certification.

- A. Check items for acceptability as major movables.
- B. Compare cost with estimate and question amounts substantially in excess. No fees of any kind are allowed.
- C. Disallow any item not acceptable as major movable and any amount not justified or supported as actual cost.
- D. Enter conclusion as a remark on Form HUD-2331 for attention of Mortgage Credit staff.

SECTION 3. - VALUATION PROCESSING

4-11. GENERAL.

- A. Underwriting Procedures. The procedures to be followed in processing an SRO application under Section 221(d) are the same as those for Section 207 with exception that the acceptable risk principle will apply in lieu of economic soundness. Estimates of value by capitalization and market comparison will not be made. The Commissioner's estimate of project replacement cost and cost supportable by net income shall be substituted for value when applying criteria which limit the mortgage.
- B. Analysis. The analysis must show a reasonable expectation that project income will, for the duration of the mortgage term, be adequate to properly maintain the property, pay all required project expenses, meet debt service requirements and provide a reasonable return to the owner's equity investment.
- C. Environmental Requirements. All projects, either new construction or substantial rehabilitation, are subject to the HUD environmental requirements of 24 CFR Part 50 as applicable.

4-12. SPECIAL SRO CHARACTERISTICS.

- A. Special Project Characteristics. The SRO has special physical, project services and tenant characteristics that distinguish it from the typical 221(d) proposal. The appraiser must consider the following characteristics in the underwriting process.
 - 1. Physical Distinctions.
 - a. SRO units are generally designed for one occupant; however, there may be additional

occupants as permitted by the local government.

- b. New construction SRO proposals must be comprised of one room units except that nonrevenue units may have more than one room per unit. Some substantial rehabilitation units may have more than one room per unit where the Field Office determines the conversion cost will be excessive; in such cases, the maximum number of units larger than one room cannot exceed more than 5 percent

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of the total number of units in a project, excluding nonrevenue producing units.

- c. At the option of the mortgagor, units may or may not contain a range/oven. Under all circumstances, SRO units shall provide minimum design features which include a sink, refrigerator, storage space for food/utensils and storage space for clothing.
- d. Units may or may not contain a shower/tub and toilet with private screening. SRO projects shall provide shared bathing and toilet facilities where they are not included in the units.
- e. SRO applicants must provide unit furnishings for each SRO unit which should consist of a bed and mattress, desk/table and chair, and dresser. To complete the appraisal process, appraisers must be cognizant of furnishings to be provided each SRO unit. Appraisers must review the list of unit furnishings submitted with SRO application materials.
- f. Projects will be designed with fewer and/or different amenities. Vending machines and social areas may be popular. Swimming pools are prohibited.
- g. SRO proposals may typically be located in urban areas or in close proximity to employment centers. SRO proposals must be carefully reviewed to determine that the processing long term project occupancy will not be jeopardized or substantially dependent upon a restricted market. For example, proposals located in seasonal employment areas must demonstrate how the processing occupancy will be maintained during the off-season. In some instances, it

may be necessary to reduce the maximum SRO program occupancy of 90 percent to an effective annualized percentage for processing.

Appraisers should also carefully review the market analyses prepared by the applicant and Field Office, with special attention to local employment trends, the diversity of the local economy, economic forecast, etc.

(4-12) 2. Services Provided by SRO Projects.

- a. Projects shall have master metering for all utilities. Projects shall include all utility services, except for phone service in the rent.
- b. Due to the less permanent nature of SRO tenancy and urban locations for most projects, greater security is indicated. For example, T.V. monitors and 24-hour desk coverage, special locks and doors may be necessary. Security cost must be considered relative to the number of units over which its cost will be spread.
- c. The provision of unit furnishings is considered a nonshelter service. The SRO applicant will complete Form HUD-92013E, Supplemental Applications Processing Form Housing for the Elderly, Section F, Furniture in Units. The appraiser will assess the reasonableness of the sponsor's projected income and expenses attributable to furnishing services by deriving an independent estimate.
- d. A SRO may provide other services that include, but are not limited to, laundry, T.V. rental, cable T.V. and use of public telephones. Premiums may also be charged for guest fees and for furniture and equipment over and above the unit furnishings. Project income and expenses attributable to such nonshelter services, as they are defined, may not be included in establishing the mortgage (projected nonshelter income and expenses are provided by the SRO applicant on HUD Form-92013E). Only income and expenses attributable to leasing basic units, commercial space and parking may be included. Net income from coin-operated washers and dryers may also be included in establishing the mortgage.

3. Tenants.

- a. SROs will largely consist of occupancy by single persons and not families.
- b. Tenants will mostly include low income wage earners and not moderate income.

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- (4-12) c. Tenant turnover rates may be high in comparison to what we encounter on typical 221 (d) (4) properties, although strong SRO demand for new and substantially rehabilitated units is anticipated.

B. Special SRO Program Requirements. The following SRO program requirements impact valuation processing.

1. Project-based HUD subsidies cannot be used in conjunction with insured SRO projects.
2. The cost of project furnishings and equipment that are eligible to be included in the project replacement cost are major movable furniture and equipment for common areas, such as lobby furniture. Unit furnishings, however, shall be funded by the SRO applicant outside of mortgage proceeds. Income and expenses attributable to the service of providing unit furnishings shall not be included in establishing the mortgage.
3. SRO unit sizes, tenants served and other project characteristics will be determined, to a large extent, by local occupancy requirements and market needs. Additionally, HUD requires the local government to certify that it has reviewed the SRO application, found there is a need within the community for the project and will ensure its best efforts to provide municipal and support services.
4. SRO applications must include a market analysis. Appraisers must review the applicant's market analysis and comment on areas of disagreement. Appraisers must also review the market analysis prepared by the Field Office Economic Market Analysis Staff and their comments to the applicant's market analysis.
5. The SRO processing occupancy factor cannot exceed 90 percent. Waiver requests to exceed 90 percent occupancy will not be considered.
6. Tenants must execute a lease of not less than 30 days; however, collections may not be more frequent than weekly,

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4-13. DATA SOURCES

- A. Pre-Program Preparation. The implementation of the SRO program will bring about new underwriting considerations and processes. To provide a timely service to SRO applicants and achieve underwriting quality, the appraisal process must be established and run efficiently. To this regard, appraisers may pursue the following suggestions:
1. Read available books and literature on SROs to gain a historical perspective of SROs through current SRO trends.
 2. Identify HUD Regional and Field Office staff who may provide assistance in the underwriting task.
 3. Establish data source contacts with local government offices that administer and monitor SROs and related housing.
 4. Establish contact with Federal and State agency departments that administer and monitor SROs and related housing.
 5. Establish contact with SRO trade organizations.
 6. Visit existing SROs, related housing, shelters and begin to maintain the data collected.
 7. Visit small hotel/motels and obtain what data you can on characteristics that are similar to a HUD SRO.
 8. Determine alternative data sources for expenses that must be estimated.
 9. Review classified advertisements for rooming house vacancies.
 10. Obtain expense data on Section 8 Moderate Rehab SRO projects located within the Field and/or Regional Office jurisdictions.
 11. Process a hypothetical SRO proposal through development branches.
 12. Establish and maintain a SRO data bank.

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- B. Pre-Application Preparation. Under the HUD SRO program an applicant's management agent must be experienced in SRO or related housing. Field Offices should request that the management agent attend the preapplication conference. The processing appraiser should also attend the pre-application conference to obtain as much information as possible regarding the derivation of Form HUD-92013 projected income and expenses.
- C. SRO Rent Data.
1. Rent data is to be documented on Form HUD-9184. Pencil in special SRO characteristics that are not shown. Form HUD-9184 instructions are provided in HUD Handbook 4480.1.
 2. Comparable Properties. SRO design and tenancy will be influenced by local market needs. Designs may range from very minimum to moderate and site locations ranging from depressed areas to very desirable locations. As a guide to defining comparability consider the following:
 - a. Most urban centers have an existing SRO housing stock. Existing SROs should be the primary source of rent data. With few exceptions, most of the data needed to estimate SRO rents, can be obtained from SRO property management, e.g., amount of rent per unit type, size of unit, unit furnishings, and amenities. More sensitive information, such as the current project occupancy, effective date of the last rent increase, and rent increase trends can often be obtained with proper HUD identification. As an additional source of rent data, the market studies prepared by the SRO applicant and HUD Economic Market Analysis Staff will also provide, among other information, data on local SRO occupancy conditions and trends. Brochures on comparable properties and a physical survey of these properties will provide additional rent data.
 - b. If existing SRO comparables are not available within a proposal's market area, the following properties may be considered comparable. Adjustments must be made as necessary for those

- (4-13) data that do not correspond to the subject's characteristics.
- (1) Rooming housing (large and small operations).
 - (2) YMCAs and YWCAs. Charges for use of recreational equipment, if any, must be deducted from this comparable's rent before using as a basis to estimate SRO rents.
 - (3) Lodging houses.
 - (4) Tourist homes.
 - (5) Youth hostels.
 - (6) Hotel/motels that have a wing licensed as an SRO.
 - (7) College dormitories.
- c. The amount or rate of adjustment that is required to bring rent comparables in line with the subject property, e.g., shared shower arrangement versus self-contained units, will, as usual, be set by the marketplace. The rate of adjustment can be extracted from the market by comparing the unit rent of SRO comparables that provide a given amenity to the corresponding unit rent of comparables that do not.
3. Properties Not Comparable.
- a. Conventional efficiency rental units will likely be much larger, provide for kitchen and bath facilities in the units, parking, swimming pools and other amenities and generally serve a population not at the risk of becoming homeless. Efficiency rental units may not be desirable SRO comparables because they typically require significant minus adjustments, however, they would delineate the upper limit.

- (4-13) b. Typically, conventional hotel/motel units are much larger, provide bathing in the units, frequently offer on site dining and room service, etc. Additionally, rents are

structured to compete on a daily basis whereas SRO units are expected to be the primary residence of the occupant. Moderate to upper income range hotel/motel units are not desirable comparables because they also require significant minus adjustments.

D. Data on Project Services Provided Tenants.

1. Market rate SROs may provide minimum nonshelter services, such as, laundry and maid services. Services may be optional or charges may be included in all unit rents. The HUD SRO unit rent will include a separate charge for unit furnishings, since, unit furnishings are not included in the project replacement cost. Services provided to tenants, such as these, are defined by HUD as nonshelter services. Proposed nonshelter services and related expenses must be identified by the applicant on Form HUD-92013-E. Income and expenses generated by nonshelter services are not considered attributable to the realty and, therefore, shall not be included in the estimate of project income, Form HUD-92264, Section C and estimate of project expenses, Section E.
2. Accordingly, nonshelter charges must be deducted from comparable rents before rent data is used as a basis to estimate SRO shelter rents. Similarly, nonshelter expenses must also be deducted from expense comparable data prior to being used as a basis to estimate SRO expenses.

Additionally, rent adjustments in the correlation process that are used to reflect the availability of nonshelter services and amenities are not permitted. Rent adjustments for availability of nonshelter services, have the effect of circumventing SRO program requirements which disallow income attributable to nonshelter services to be included in the shelter income.

3. In addition to laundry and maid services, other SRO optional or mandatory nonshelter services may include but are not limited to cable TV, TV rental,

- (4-13) guest fees, social and recreational services. Congregate dining or food services are not permitted as a shelter or nonshelter service. Swimming pools are also not permitted under the SRO program.

4. The appraiser's estimate of income for each proposed nonshelter service is critical in evaluating the feasibility of SRO proposals. Over-estimation of the market demand for proposed nonshelter services and/or the amount of nonshelter service charges will inappropriately require shelter income to cover any excess nonshelter expense attributable to the service. This will diminish the projected shelter income's ability to meet intended vacancy and collection losses, shelter expenses and debt service. The amount of nonshelter service charges must be supported by market data. To estimate the market income and expense attributable to nonshelter services, cross-check the following data sources:
 - a. Charges imposed and expenses incurred by comparables.
 - b. A comparison of project rents charged by comparable SRO's offering nonshelter services to those that do not.
 - c. Check Field Office Housing Management Form HUD-92410 5300 series revenue accounts and 6900 series expense accounts on currently insured housing that provide nonshelter services.
 - d. Review the applicant's projected nonshelter income and expenses reported on Form HUD-92013-E for reasonableness. Follow outstanding Form HUD-92013-E instructions on the reverse of the form.

E. SRO Expense Data.

1. Expense data is stored on Form FHA-2275. Instructions for completing the 2275 are contained in Appendix 3. The expense data required to complete the 2275 is provided by the Housing Management Form HUD-92410 which is a annual financial report on each existing multifamily insured property. Insured SRO's will also be

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- (4-13) required to submit annual 92410's; however, at the outset of the SRO program, Field Offices will not have 92410 data on SRO's to transcribe to the 2275. This will not occur until a SRO proposal is fully developed and in operation 1 year.
2. Nevertheless, the 2275 can be used to record SRO expense data that is obtained from other sources.

The Appendix 3, 2275, instructions identify the individual 92410 accounts that comprise each 2275 expense item. The name and definition associated with each account number is provided in HUD Handbook 4370.2 CHG-1, Financial Operations and Accounting Procedures for HUD Multifamily Housing Projects. The Appendix 3, 2275, instructions can, therefore, be used as a guide to record SRO expense data in a manner that is consistent and acceptable/useful to the Department. Unique SRO expense items that are not considered to be nonshelter expenses may be penciled in.

3. The above guidelines for SRO rent comparability are also appropriate to identify expense comparables.
4. Typically, annual expense data on at least three comparable properties are used as a basis to estimate expenses for Section 221 (d) (4) proposals. Until SRO expense data is available and/or sufficient, it may be necessary to use data from other sources in tandem with data received on comparable properties. For example, Field Office engineers' may estimate a project's annual utility expense given several project characteristics and local utility rates. Field Office housing management staffs' will review SRO management plans and therefore, provide a source of data to estimate SRO management fees and payroll expenses. Current 92410s on 221 (d) (4) properties may provide data to estimate expenses also common to SROs. As an example, 92410s on 1-4 story elevator properties will provide documentation to estimate SRO elevator expenses. Another source of expense data may be the SRO management agent who must be experienced in SRO or related housing development. All data must be analyzed for reasonableness. The derivation of all SRO expense estimates adjustments, etc. must be documented in projects files.

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- F. Data on Tenant Income. An SRO application will identify the general tenants a project will serve. For example, if a SRO proposal intends to appeal to the local retail work force, their disposable income after taxes may be estimated by reviewing local wage rates and deducting local and Federal taxes and FICA payments. This will indicate the plausibility of tenants to meet the projected rent. This analysis should be considered in conjunction with other market rent data.

- G. Market Analysis Data. The applicant is required to provide a market analysis and rent comparables. This is also a data source.

4-14. VALUATION ANALYSIS.

- A. Purpose. To evaluate the property as security for a long-term insured mortgage.
- B. Estimated Rents. SRO rents are estimated on Form HUD-92273. Pencil in special SRO characteristics, such as shared baths, etc. that are not shown. Nonshelter service charges that are reflected in comparable rents must also be shown and minus adjustments made. Form HUD-92273 instructions are provided in HUD Handbook 4480.1. Additionally, consider the following:

- 1. Unit of Comparison Used to Estimate SRO Rents.

- a. All SRO unit rents must be derived based upon comparable market data. SRO rents will be estimated on a per unit basis. Processing rents on a per person and/or per bed basis shall not be used. Differences between a proposal's estimated unit rents, if any, may be attributable to physical design characteristics, such as, unit size. Differences in proposed SRO unit sizes are recognized and adjusted for in the rent correlation process in accordance with the outstanding instructions of Form HUD-92273. The rate of adjustment for physical characteristic differences is as always based upon market data.
- b. Local SRO market rent data may indicate that weekly rates as opposed to monthly charges are

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(4-14) more typical. HUD SRO tenants will be required to execute a monthly lease of not less than 30 days and collections cannot be more frequent than weekly. To facilitate the estimation of SRO rents, SRO rents may be derived on a per unit per week basis. In the Remarks section of Form HUD-92273, the weekly rent must be multiplied by a factor of 4.33 to be converted to a monthly rent which is used in Section C, Form HUD- 92264.

- 2. Unit Occupancy. SRO units may be designed to allow more that one occupant. Local occupancy

requirements will determine the maximum number of occupants permitted to reside in a unit.

If the SRO applicant intends to charge a premium for an additional person(s) per unit above the projected unit rent (that has been estimated on a per unit basis and already reflects consideration for unit size), this additional charge is considered nonshelter income and must be reported on Form HUD-92013E. The planned budgeted charge for a additional person(s) per unit, must be shown and based upon market data. The effect of multiple occupancy units must be considered in the estimation of nonshelter expenses, such as maid and linen services and additional unit furniture and furniture maintenance, etc.

3. Other Project Income. Income from coin operated washers and commercial space is separately considered on Form HUD-92264, Section C. Commercial space, exclusive of the space for machines, will be limited to 10 percent of the total gross floor area (20 percent in substantial rehabilitation cases) or 15 percent of gross rental income. Commercial activity must be compatible with use of the project and primarily serve the tenants.

C. Estimate Of Expenses. SRO expenses are estimated on Form HUD-92274. Pencil in special SRO expense items, that are not considered nonshelter expenses.

1. Expense Unit of Comparison. It is expected that most SRO expense data will be available on a Per Unit Per Annum (PUPA) basis. However, other units of comparison may be used, such as, expense per square foot or expenses expressed as a percentage of effective gross project income.

- (4-14) 2. Atypical Expenses. SRO expenses may differ in comparison to 221(d) operations, particularly the management fee, security and utility expenses.

4-15. Valuation Processing Changes.

- A. The maximum occupancy percentage of Section F, Occupancy Percentage is 90 percent.
- B. Insert under Section G, below Total Legal, Organization and Audit, an item entitled movable Equipment. The amount entered will reflect the cost of major movable common area furnishings and equipment. The cost analyst will provide this amount under the Remarks

Section of Form HUD-92264.

- C. Insert under Section E, below Replacement Reserve, a separate Replacement Reserve for Major Movable Equipment. Calculate by multiplying the common area major movable amount provided by the cost analyst under B above by 10 percent.
- D. Section 221(d), 0 bedroom statutory mortgage limit shall be used to compute the trial Form HUD-92264 A mortgage amount for SRO one room units. Units that may be larger than one room, e.g., nonrevenue producing units and a maximum of 5 percent of substantial rehabilitation revenue units, must use the statutory limit that corresponds to the SRO unit size. For example:

Project Unit Type	Applicable Statutory Limit (221)
One Room.....	0 bedroom
Two Rooms.....	0 bedroom
Zero Bedroom (efficiency unit).....	0 bedroom
One Bedroom..(full living unit)....	1 bedroom
Two Bedroom..(full living unit)....	2 bedroom

A two-room unit may include an enclosed kitchen and one additional room under the provisions of paragraph 4-2.

- E. The Form HUD-92013E is used in tandem with many HUD programs and must be adjusted to accommodate special program characteristics. The instructions provided on the reverse of the form for completing Furniture in the Unit, Line F (2) (a), states that, "The renting of furniture by a tenant must be optional and not a

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(4-15) condition of occupancy." Under the SRO program, the mortgagor must provide unit furnishings. Accordingly, nonshelter replacement reserve for unit furnishings must cover the cost of furnishings for all SRO units.

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SECTION 4 THE MORTGAGE CREDIT PROCESS (ANALYSIS)

4-16. BASIC SOURCE-BOOK. Except as modified here, basic mortgage credit processing instructions are in HUD Handbook 4470.1,

Mortgage Credit Analysis for Project Mortgage Insurance
Section 207.

- 4-17. TOTAL REQUIREMENTS FOR SETTLEMENT, Section II of Form HUD-92264-A, Supplement to Project Analysis. It is essential to determine the net amount of cash or its equivalent needed to close a transaction.
- A. In the SRO program the mortgagor must purchase unit furnishings.
 - B. The mortgagor must submit a list of items to be purchased and the estimated cost of each item.
 - 1. The Cost Analyst will review the mortgagor's estimated cost of major movable furnishings and equipment (including unit furnishings) for reasonableness.
 - 2. Mortgage Credit will require the establishment of a separate escrow to cover the cost of unit furnishings. The escrow is based on the greater of HUD's estimate or the mortgagor's estimate for unit furnishings plus the mortgagor's estimated cost for other minor nonrealty items.
 - C. Based on the submitted relocation plan, a maximum of \$500 per unit may be included in the estimated replacement cost. If the mortgagor's estimate exceeds the \$500 allowance, an escrow must be established to satisfy the difference.

4-18. BUILDER-SELLER MORTGAGOR UNDER SECTION 221(d) (3)

- A. Before applying for project mortgage insurance, the mortgagor enters into an agreement (satisfactory to HUD) with a private nonprofit corporation eligible for insurance.
 - 1. The builder-seller mortgagor agrees to sell the project, on completion, to the nonprofit for no more than certified cost of the project.
 - 2. If the sale is not consummated, the project will be operated as a limited distribution rental project.

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- B. Prepare two Forms HUD-92264-A to determine the maximum insurable mortgage (MIM) for:
 - 1. Limited distribution mortgagor.

2. Nonprofit mortgagor.

C. Withhold the difference between the two MIMs developed above until the project is sold.

4-19. INSURING ADVANCES

A. Initial/Interim Advances. Use basic Section 207 instructions except as modified here by paragraphs 5-18.

B. Approval of a Final Advance for a builder-seller mortgagor may be conditioned on escrowing a portion of the mortgage proceeds until closing the sale to nonprofit mortgagor.

4-20. COST CERTIFICATION PROCEDURES.

A. Use HUD Handbook 4470.1 instructions except as modified here.

B. Certification purposes in builder-sponsor cases:

1. To establish the maximum insurable mortgage for limited distribution mortgagor.

2. To establish the ceiling price at which the project may be sold to a nonprofit mortgagor.

4-21. MORTGAGE REDUCTION AFTER COST CERTIFICATION

A. Adjustments for Undetermined Costs or Escrows

1. The law requires that the mortgage will not exceed the applicable percentage of actual costs.

2. The Agreement and Certification provides that where the Commissioner accepts, for cost certification, estimates of cost for any item the later substitution of certified actual costs may require a reduction of the mortgage.

(4-21) 3. Reductions of cost may arise from:

a. Refunds, rebates, or discounts.

b. Excess of escrows over the actual costs of incomplete construction items.

c. Refunds of deposits by the mortgagor to prevent losses to the mortgagee in connection with the

sale of the mortgage (as set forth in Mortgagee's Certificate, or Request for Final Endorsement of Credit Instrument).

- d. Settlement of claims against bonding companies or others after project completion.
- B. At final endorsement, the mortgagor must set up a cash escrow at final endorsement to pay all "cash items" identified on Form HUD-92330, Mortgagor's Certificate of Actual Cost, and debts to third parties who made the original disbursement for any item listed as paid on Form HUD-92330.
1. Reconcile the difference between:
 - a. Obligations listed on the Request for Final Endorsement of Credit Instrument Form FHA 2023 or FHA 2455 (For Insurance Upon Completion Projects Only); and
 - b. The "to be paid" column on Form HUD-92330 plus debts to third parties.
 2. The difference must be supported by paid receipts and a statement from the mortgagor identifying by name and cost, those items paid in cash. The receipts and statement are affixed to the Form FHA 2023/2455.
 3. Personal checks issued at final endorsement are not acceptable. Payment must be in certified funds or cashier checks.
 4. Deduct obligations listed as "paid" or "to be paid" on Form HUD-92330, which are represented at final endorsement as paid by FHA approved notes. Prepare a new Form FHA 2580 from the total of HUD approved cost on Form FHA 2331A.

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- (4-21) 5. Undisbursed mortgage proceeds may supplement or satisfy the cash escrow.
6. Use Form HUD-92476-1, Escrow Agreement for Unpaid Construction Costs.
 - a. To set up the cash escrow.
 - b. Attach a detailed listing of the unpaid costs.
7. Use Form HUD-92464, Request for Approval of Advances of Escrow Funds, to disburse escrow.

8. Escrow should be disbursed within 45 days after final endorsement. If all the funds are not disbursed follow the procedures in C below.
9. At final endorsement, if all obligations have been paid in cash, nothing else is needed.

C. Sixty days after final endorsement:

1. Prepare a new Form FHA 2331A, Cost Certification Review Worksheet. Enter under the column heading:
 - a. "2264" - the amount of each item of cost recognized from the previous Form FHA 2331A "Allowed" Column.
 - b. "2330/2330A" - the amounts listed in Column C of the Mortgagor's Certificate of Actual Cost, Form HUD-92330 for each item of cost.
 - c. "Allowed" - the amounts paid in cash based on the reconciliation performed in paragraph B above and disbursements from the cash escrow account.
 - d. "Disallowed" - the lower of the amounts previously allowed or paid in cash.
2. Compute a new Maximum Insurable Mortgage, Form FHA 2580 based on the total of the "Disallowed Column", Form FHA 2331A above. If this computation produces an amount less than the finally endorsed mortgage:
 - a. Notify the Directors of Housing Development and Management by memorandum that prepayment to the mortgage is required.

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- b. Prepayment is mandatory and is applied:
 - (1) In amounts equal to the scheduled monthly principal payments, to the extent possible.
 - (2) Any remainder goes to the Reserve for Replacements Fund.
 - c. If the Field Office is notified that payment has been delayed because of a dispute or litigation, retain funds to pay the amount pending resolution of the dispute.

- d. Notify the escrow agent of the required payment.
 - e. Control the remaining balance in a special account, as a reserve for unpaid construction costs.
3. Continue to use the existing amortization schedule for servicing the mortgage.
- a. The prepayment is in addition to the regular monthly payments to principal.
 - b. There is no adjustment in the annual MIP due because of these mandatory prepayments to principal.
- D. The escrow requirement does not apply to funds the general contractor owes. However, the general contractor must submit a reconciliation of its "to be paid" items.

4-22. BOND FINANCED PROJECTS.

- A. HUD does not review financing documents associated with mortgage bonds.
- 1. The sponsor must submit, with the application for commitment processing, a separate statement covering the estimated costs of issuance, discounts and financing fees to be paid out of pocket by the sponsor/mortgagor.

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- (4-22) 2. Mortgage Credit:
- a. Checks the statement for reasonableness, using the data from previously processed bond financed projects.
 - b. Make upward adjustments where appropriate.
 - c. Uses this information to develop the Total Estimated Cash Requirements on the back of Form HUD-92264-A, Supplement to Project Analysis.
3. The construction loan and permanent loan rates may exceed the interest rate on the obligations. For tax-exempt bonds, the spread between the two interest rates is controlled by the Treasury's arbitrage regulations.
- a. The mortgagee must explain the necessity of the

spread; for example, it may be used to pay the servicing fee on the obligations.

- b. The spread may not be used to:
 - (1) Fund a debt service reserve account.
 - (2) Replace any letters of credit posted by the mortgagor for either the mortgage or the bond transaction.
 - (3) Cover negative investment income during construction or capitalized interest after final endorsement.

- c. The mortgagor should submit a copy of the written financial commitment from the bond underwriter to the issuer of the obligations.
 - (1) The commitment states the interest rate and conditions of purchase.
 - (2) If the commitment is unavailable, the issuer of the obligations must estimate the projected interest rate of the obligations. In such cases:
 - (a) The firm commitment must contain the following condition:

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"Any interest savings resulting purely from a differential between the HUD processed interest rate and the actual final interest may not be construed as excess funds that may be used to offset costs in other categories at the time of cost certification. Any such savings must be applied as a mortgage reduction."

- (b) An exception is that savings resulting from the early completion of construction may be used to offset cost certifiable overruns in other cost categories. Compute interest savings by:

- 1 Recalculating the interest line item on Form HUD-92264, using the actual interest rate for the scheduled construction period.

- 2 Subtracting the actual interest cost recognized at cost certification from the revised interest figure developed in 1 above.

B. Bonds may be sold at a premium to investors, i.e., investor pays an amount in excess of the face value of the bonds.

1. The premium results from the bonds carrying a higher coupon rate than is generally available in the marketplace.
2. The premium on the bonds must be considered excess investment income.
3. The premium may be used to pay for additional costs associated with the issuance of the obligations.

C. Attached to and reflected in the Mortgagee's Certificate, Form PHA 2434, is an itemized statement of the costs of issuance of the obligations, discounts, and financing fees paid through the mortgagee.

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1. The statement must explain why each individual item is necessary for the issuance of the obligations.
 2. Review the amount of each item to ensure its reasonableness in relation to comparable projects.
 3. Prepare a letter for the Director of Development's signature, informing the mortgagor that HUD will recognize the cost for certification purposes:
 - a. The costs of issuance, discounts, and financing fees in an aggregate amount not to exceed the 3.5 percent included in the mortgage.
 - b. Exception may be made for additional charges if the sponsor/mortgagor could not benefit monetarily from excess investment income from the proceeds of the invested obligations.
 4. The mortgagee, bond underwriter, and issuer have the option of deferring collection of additional discounts, financing fees, slow draw fees, etc., through provisions contained in the Mortgagee's Certificate.
 - a. The deferred collection of these items must be an obligation of a third party and both the

third party and the mortgagee, bond underwriter or issuer must attest in writing that they will not look for payment from:

- (1) Mortgagor.
 - (2) Mortgaged property.
 - (3) Mortgage proceeds.
 - (4) Any reserve or deposit required by the Commissioner or mortgagee in connection with the mortgage transaction.
 - (5) Rents or other income from the mortgaged property.
- b. The mortgagor entity may issue as evidence of the debt a surplus cash or residual receipts note to the third party.

D. Explain at the pre-cost certification conference that:

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1. If more than 3.5 percent in total financing fees is requested to be included in the mortgage calculation at cost certification for any reason, the mortgagor's accountant must detail in the notes to the financial statement:
 - a. Amount of interest paid on the obligations.
 - b. Source of the interest payments.
 - (1) Construction loan proceeds.
 - (2) Monies advanced from the developer.
 - (3) Excess investment income.
 - c. Net amount of excess investment income.
 - d. Disposition of all escrowed funds, including any excess investment income, as specified in the trust indenture.

For example:

 - (1) Payment of HUD-insured project costs.
 - (2) Payment of interest on the bonds.

- (3) Retirement of the bonds.
 - (4) Reimbursement of any remaining investment income to either the issuer of the obligations or the mortgagor entity.
- 2. Don't recognize any costs paid by funds generated from the sale of bonds in excess of par.
 - 3. Net excess investment income used to pay project costs will be treated as project income and used to reduce the total allowable costs after the calculation of BSPRA/SPRA.
 - 4. Net effect of negative interest arbitrage (capitalized interest) may be recognized if there are offsetting savings in the mortgage, provided that the:

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 - a. Arrangements for collecting capitalized interest were spelled out in the Mortgagee's Certificate, Form FHA 2434.
 - b. Developer could not benefit monetarily from possible excess investment income.
- 5. Any rebate to the sponsor/mortgagor from either the mortgagee, issuer, or bond underwriter automatically reduces the mortgage at cost certification. The following are two samples of the most common types of rebates.
 - a. Mortgagee/bond underwriter contributes part of the initial service charge to pay discounts or other fees.
 - b. Mortgagee/bond underwriter refunds part of the construction loan interest to the mortgagor or sponsor.
- 6. Item 5 above may result in a definite hardship to the mortgagor if the mortgage was originally limited by a criterion other than cost and the reduction in cost resulting from the rebates would not otherwise reduce the mortgage. In such cases:
 - a. Reprocess Form HUD-92264 to adjust the cost estimate to reflect the reduction in cost resulting from rebates.

- b. Recalculate the replacement cost mortgage and compare it to the original committed mortgage to determine if the required reduction is warranted. If not, you should issue Form FHA 2580, Maximum Insurable Mortgage, reflecting no mortgage reduction attributable to the rebates.