

CHAPTER 1. INTRODUCTION TO SERVICING COINSURED LOANS

1-1. GENERAL INSTRUCTIONS

- A. Follow the instructions in Chapter 1 of HUD Handbook 4566.2, Management, Servicing and Disposition Requirements for Projects with 223(f) Coinsured Loans, except for the paragraphs listed below. These paragraphs do not apply to projects with 221(d) coinsured loans.
- Paragraph 1-13: Administer any special escrows required at closing
 - Paragraph 1-14: Monitor implementation of required management improvements
- B. Follow the instructions in this supplement for administering construction-related and operating deficit escrows and monitoring compliance with HUD's affirmative fair housing marketing requirements.

1-2. ADMINISTERING CONSTRUCTION-RELATED ESCROWS. The lender's construction loan servicing staff is responsible for administering and closing out the escrows that were established during construction or rehabilitation.

- A. Escrow for delayed completion items. This is a cash escrow. It should have been established at loan closing and should equal 2 1/2 times the estimated cost of completing items that were not finished when you determined the project was "substantially complete."
- 1) Reach agreement with the owner and contractor on a schedule for completing the unfinished work.
 - 2) Follow paragraph 14-8 of HUD Handbook 4561.1, Coinsurance for Mortgage Lenders (Section 221(d)), for:
 - a) verifying completion of work items;
 - b) disbursing escrow funds;
 - c) completing any items the owner and contractor fail to complete; and
 - d) closing out the escrow when all items have been satisfactorily completed.
 - 3) If there is a default before you have fully disbursed this escrow, you must apply the undisbursed balance as an offset against the claim. (See Chapter 11 of this Handbook and Chapter 11 of HUD Handbook 4566.2).
- B. Latent defects guarantee. The Construction Contract (Form HUD-92442) requires the contractor to guarantee all construction or

rehabilitation work against defects that appear within 12 months after the date of substantial completion. This 12-month limitation does not apply to the correction of nonconforming work (as that term is defined in the Construction Contract).

- 1) Types of guarantee. The latent defects guarantee may have been given as a bond, cash escrow or letter of credit. The guarantee must be maintained for at least 18 months.
 - a) If the contractor and owner signed a Completion Assurance Agreement (Form HUD-92450), the guarantee is a cash escrow or an unconditional and irrevocable letter of credit equal to 2 1/2 percent of the construction contract amount.
 - b) If assurance of completion was through a surety bond (Form FHA-2452), the bond includes a 12-month guarantee against latent defects.
 - c) If assurance of completion was through a personal indemnity agreement (Form FHA-2459), the guarantee is a cash escrow or an unconditional and irrevocable letter of credit equal to 2 1/2 percent of the mortgage principal.
 - d) If the project was insured upon completion and the contractor signed a Surety Bond Against Defects Due to Defective Materials and/or Faulty Workmanship (Form FHA-3259), the bond is 10 percent of the estimated cost of construction or substantial rehabilitation.

C. Guarantee Inspections

- 1) Scheduling. Establish a "tickler system" for each project to alert staff to critical dates relating to the construction guarantee and follow-up actions. The tickler system must show:
 - a) Date of substantial completion
 - b) Date 12 months after substantial completion, when the guarantee period ends
 - c) Date 18 months after substantial completion, when the bond or letter of credit expires or any cash escrow must be released
 - d) Dates for guarantee inspections. These must be in the first week of the 9th and 12th months to allow time for reports, notification of principals, and follow-up activities within those months.

- 2) Ninth-month inspection
 - a) Identify all latent defects.
 - b) Promptly notify the owner, contractor and surety (if applicable) of all defects. The letter must:
 - 1) require the contractor to correct all defects before the 12th-month inspection; and
 - 2) be sent by registered mail/return receipt requested.
- 3) Twelfth-month inspection
 - a) Determine whether defects cited in the ninth month inspection report have been corrected.
 - b) Identify any defects not apparent during the ninth month inspection.
 - c) Follow the notification procedures in subparagraph C.2b) above. Your letter must do the following:
 - o Acknowledge any correction of previously reported defects.
 - o List any newly-discovered defects and any defects outstanding from the ninth month inspection.
 - o Require the contractor to provide written assurance that any defects will be corrected before the end of the 18-month guarantee escrow period.
 - d) If all previously noted defects have been satisfactorily corrected and no new ones are apparent, you must notify the owner, contractor and surety (if applicable).
- 4) Follow-up actions
 - a) If the contractor gives written assurance but cannot correct the defects within the escrow period, get an extension of the cash escrow or letter of credit.

NOTE: You will generally not need to get an extension of a surety bond since the bond automatically covers two years from the date of the final payment under the Construction Contract.

- b) If the contractor does not correct the defects

within the guarantee or extended escrow period, you must either:

1-3

6/85

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- o use escrow funds or funds available under a letter of credit to correct the defects; or
 - o make a formal demand on the surety. (NOTE: You must do this before two years have elapsed from the date of the final Construction Contract payment.)
- 5) Release of funds. You may return to the owner any excess escrow funds or undrawn balance under a letter of credit ONLY WHEN
- o all defects have been corrected

AND

- o 18 months have elapsed since the date of substantial completion

1-3. ADMINISTERING OPERATING DEFICIT ESCROWS

A. General. If, during underwriting, staff estimated that the project would not reach sustaining occupancy before amortization began, the lender should have required the owner to sign an operating deficit escrow agreement at closing.

- 1) HUD Handbook 4561.1 explains how the operating deficit was estimated. The agreement sets the escrow amount and conditions for use.
- 2) To effectively administer the escrow, the lender's servicing staff must review the agreement and the underwriter's projections of occupancy levels, collections, and expenses.

B. Owner's reporting requirements. During the escrow period, the owner must give the lender monthly reports on the project's:

- 1) collections
- 2) outlays
- 3) accounts payable
- 4) cash balances
- 5) occupancy levels
- 6) marketing activities

C. Lender's monitoring requirements

- 1) Review the owner's monthly reports

- 2) Compare the project's actual occupancy levels and cash flow deficits with the projections on which the escrow was based.
- 3) Monitor the owner's/agent's marketing. If there are problems, work with the owner and agent to determine the causes and develop solutions.

6/85

1-4

D. Drawdown of funds

- 1) The owner must compute actual deficits on a cash, rather than an accrual, basis.
- 2) The owner's requests for funds must be in writing and must accompany the monthly reports described in subparagraph B above.
- 3) You may release funds only according to the escrow agreement.

E. Extension of escrow period. If it appears the project will not reach sustaining occupancy by the end of the escrow period or if the owner's drawdown exceeds your initial projections, you must:

- 1) Determine the cause of the project's failure to achieve projected or sustaining occupancy. Those causes could include:
 - o inadequate marketing
 - o units not ready for occupancy
 - o poor market conditions
- 2) Determine the actions needed to improve the project's marketing and/or management. (This could require changing management agents.)
- 3) Redetermine the time it will take to reach sustaining occupancy. Consider:
 - o the project's past and current rates of rent-up
 - o whether marketing/management improvements are needed
- 4) Estimate the additional funds the project will need to carry it through the deficit period. Consider the:
 - o time it will take to reach sustaining occupancy
 - o project's past and current income and expenses (Make sure expenses are reasonable.)

- 5) Do one or more of the following to increase the escrow deposit and extend the escrow period:
 - a) Ask the owner to increase the escrow by a cash advance or additional letter of credit.

1-5

6/85

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- b) Suggest a transfer of physical assets to bring cash into the project.

F. Applying funds after a default. If the project defaults and you accelerate the debt, you must apply any amount remaining in the operating deficit escrow as an offset against your claim. (See Chapter 11 of HUD Handbook 4566.2.)

1-4 MONITORING IMPLEMENTATION OF AFFIRMATIVE FAIR HOUSING MARKETING REQUIREMENTS. (The Affirmative Fair Housing Marketing Plan Requirements in this paragraph do NOT apply to units assisted under the Section 8 Moderate Rehabilitation Program. For those units, see the Equal Opportunity Housing Plan Requirements in HUD Handbook 7420.3 REV-2, Section 8 Housing Assistance Payments Program - Existing Housing and Moderate Rehabilitation Processing Handbook.)

A. Project owners and management agents must comply with:

- 1) the project's HUD-approved Affirmative Fair Housing Marketing Plan
- 2) applicable fair housing laws and regulations
- 3) Chapter 4 of HUD Handbook 8025.1 REV-1, Implementation of Affirmative Fair Housing Marketing Requirements.

B. The Field Office Fair Housing and Equal Opportunity (FHEO) Division has the primary responsibility for monitoring the owner's/agent's compliance. The FHEO Division may periodically conduct on-site reviews of affirmative marketing activities.

C. Owners and agents must submit to HUD any reports required by the Field Office FHEO Division.

D. The lender must check the owner's/agent's compliance with the affirmative fair housing requirements described in Chapter 4 of HUD Handbook 8025.1 REV-1 when conducting an on-site management review. (See Chapter 6 of this handbook for monitoring guidance.)

E. If the lender suspects that the owner or agent is violating fair housing laws or regulations or is not complying with the project's Affirmative Fair Housing Marketing Plan, the lender must report this to the Field Office FHEO Division.

