CHAPTER 6: ON-SITE REVIEWS

Section 1. Types and Frequencies of Reviews

6-1. INTRODUCTION. On-site reviews are an integral part of the lender's monitoring of project operations. While desk reviews of project operations (i.e., reviews of financial reports, rent increase requests and requests for withdrawal from the reserve for replacements) can alert the lender to general financial trends in project operations, such desk reviews do not enable a lender to determine the cause of the problems detected in desk reviews or to identify other deficiencies in the project's physical condition or operating procedures that could threaten project viability. On-site reviews can assist lenders in making these determinations and in negotiating solutions to project problems. On-site reviews can also provide documentation to support enforcement actions which become necessary when owners/agents will not voluntarily implement corrective actions. Thus, lenders must perform two types of on-site project reviews: (a) physical inspections; and (b) management reviews. Lenders must conduct these reviews in accordance with the procedures set forth in this Chapter.

6-2. PHYSICAL INSPECTIONS. Physical inspections take a detailed look at the condition of the project's buildings, grounds and mechanical systems and assess whether project management is completing preventive and corrective maintenance in a regular or timely fashion. Generally, the inspection should examine the condition of the items listed on Form HUD-9822, Report of Physical Condition and Estimate of Repair Costs. This Form is shown in Appendix 20. The coinsurance regulations and the Mortgagee's Certificate require that the lender complete physical inspections annually. The lender should generally schedule the first annual physical inspection to coincide with the first anniversary of the date the mortgage was endorsed for insurance. In addition to the required annual physical inspection, the lender should inspect the property when other servicing activities (e.g., management reviews, excessive demands on the reserve for replacements, unusually high or low maintenance outlays, etc.) indicate that physical problems are developing. The lender should also conduct physical inspections as needed to monitor implementation of any required repairs or physical improvements.

6-3. MANAGEMENT REVIEWS. While management reviews take a "big picture" look at a project's physical condition, management reviews focus primarily on operating policies and procedures. Management reviews evaluate the adequacy of both the procedures for carrying out day-to-day, front-line activities (e.g., maintenance and leasing) and the procedures for directing and overseeing project operations. Management reviews can look at all or only some of the management tasks listed on the Form HUD 9838, Management Review Report for Unsubsidized Multifamily Family Housing Programs. This form is shown in Appendix 21a.

a. When Reviews Are Recommended. The lender' should consider conducting an on-site management review:

(1) following a change in management agents;

(2) when the lender's desk reviews or other servicing activities indicate that physical, financial or management problems exist and the extent or cause of the problems is not immediately apparent;

(3) when the project is managed by an agent whose performance deficiencies are causing problems at other projects;

(4) prior to approving mortgage relief;

(5) prior to giving preliminary approval of a transfer of physical assets application; or

(6) as necessary to effectively monitor the owner's implementation of any required corrective actions or project improvement efforts.

b. Determining the Scope of the Review. The lender should adapt the review to the physical and financial conditions of the project, the past performance of the management agent, and the purposes for which the review is being conducted. Some examples of adapting the review are given below.

(1) If the purpose of the review is to assess the performance of an agent with which the lender is not familiar, the lender should look at all or a majority of the management tasks listed on the Management Review Report for Unsubsidized Multifamily Housing Programs, Form HUD-9838.

(2) If the lender is already familiar with the agent's performance either at this or at other projects, the lender may look only at a sample of the more important management tasks (i.e., cost controls, budgeting, preventive maintenance, tenant screening and selection, training and supervision of staff); If the lender has seen problems with some aspects of the agent's performance, the review should focus on those areas.

(3) If the purpose of the review is to determine the cause of cash flow problems, the lender should identify possible causes and look at specific management tasks related to those problems or causes. For example:

(a) If operating expenses are higher than those of comparable projects, the lender should check cost control procedures (e.g., bulk purchasing, taking advantage of discounts, comparing prices, preparing budgets and monitoring actual expenses against budgeted amounts).

(b) If the vacancy rate is higher than at comparable projects, the lender should assess the project's appearance and curb appeal and review the project's procedures for readying units for occupancy following move-out.

(c) If turnover is high, the lender should check tenant selection and screening, management's responsiveness to tenant complaints and repair requests, and the quality of maintenance.

(d) If accounts receivable are high, the lender should check procedures for collecting rents, identifying and tracking delinquencies, following up on delinquent accounts and evicting delinquent tenants.

(4) If requests for withdrawal of replacement reserve funds show more frequent than usual replacement of appliances or equipment, the lender should check preventive maintenance procedures and the quality of goods purchased.

6-4. RELATIONSHIPS BETWEEN TYPES OF REVIEWS. On-site management reviews are designed to be used in conjunction with other lender reviews (physical inspections and annual financial statement reviews). On-site management reviews should not duplicate activities performed in other reviews. The following paragraphs describe how management reviews relate to other lender reviews.

a. Relationship of Management Reviews to Physical Inspections. The maintenance and security section of the management review takes a general look at the project's physical condition -- Is the project well-maintained? Are the grounds in good shape? Does the project need painting? The physical inspection takes a more detailed look at the physical condition of a project and often needs to address mechanical and structural problems (e.g., drainage problems, air conditioning, heating repairs, etc.). While the management review can easily be completed by a Loan Servicer, the Report of Physical Condition is more appropriately completed by someone with a construction or engineering background (e.g., a Maintenance Engineer, Construction Analyst, etc.). Physical inspections can be used to determine the cause of or solution to problems first detected through the management review's cursory checks on physical condition.

b. Relationship of Management Reviews to Desk Reviews of Financial Statements. Management reviews can help the lender determine the cause of problems (e.g., poor rental collections, high expenses, etc.) detected in desk reviews of financial statements. While management reviews evaluate the owner's and agent's systems of cash and cost controls, management reviews are not designed to detect diversions of project assets. Diversions can more efficiently be detected by the Independent Public Accountant's (IPA's) audit work or the lender's desk review of the project's annual financial statement.

Section 2. Preparing for and Conducting the On-Site Review

6-5 OWNER/AGENT NOTIFICATION. The lender should call the owner/agent at least two weeks before the date the lender wishes to conduct the review. At that time, the lender and owner should: (a) reach agreement on a review date; and (b) determine the location of records to be reviewed (i.e., agent's office or project site). The lender should let the owner/agent know if it intends to inspect occupied units so that the owner or agent can notify tenants in advance.

6-6. CONDUCTING THE REVIEW.

a. Entrance Conference. Upon arrival at the project, the lender's representative should meet with the owner and agent to explain the purpose of the visit; outline the review approach to be used; determine the location of pertinent records; and set an appropriate time for the close-out conference that will be held at the end of the review.

b. Review Process. HUD does not prescribe how the lender should conduct the on-site review. The review should generally include a combination of interviews with the on-site staff and the agent, reviews of project files and records, unit inspections and a walkthrough of the project. The lender should structure the review to carry out the purpose for which the review was scheduled. For management reviews, the lender may wish to use some or all of the Management Review Worksheet shown in Appendix 21b. Use of this Worksheet is optional.

c. Close-Out Conference. At the conclusion of the on-site visit, the lender should discuss his/her observations and conclusions with the owner/agent. The lender must give the owner/agent an opportunity to explain their opinions of the causes of any problems and to provide recommendations for corrective actions. The reviewer should attempt to reach agreement with the owner/agent on the cause of the problems, corrective actions needed, and target completion dates. The lender should summarize and record the owner/agent's comments.

Section 3. Preparing and Processing Review Reports

6-7. CONTENTS OF REPORT. The lender's report of the on-site review must include: (a) a statement of the scope and method of review; (b) findings and corrective actions recommended/required of the owner; (c) the rating of the owners/agent's performance; and (d) the date the owner's response is due. The lender may use the Report of Physical Condition and Estimate of Repair Costs (Appendix 20) or the Management Review Report for Unsubsidized Multifamily Housing Programs (Appendix 21a), or may develop and use its own report format. Instructions for completing these Forms are contained on the top of each Form.

6-8. RATINGS. When preparing reports on on-site reviews, lenders should assess both the acceptability of current project conditions and the effectiveness of systems and procedures in use at the project. When evaluating an owner or agent who just recently assumed ownership/management responsibility, the lender must consider what conditions existed at the time the owner/agent assumed responsibility for the project and whether any current adverse conditions were caused by factors within the control of the owner/agent.

6-9. INITIAL DISTRIBUTION OF REPORT. The lender must mail the physical inspection or management review report to both the owner and the management agent. If the report contains serious findings, the transmittal letter should advise the owner/agent that these findings could adversely impact future requests for previous participation clearance.

6-10. LENDER FOLLOW-UP EFFORTS.

a. Securing a Response. If the owner does not respond within the time-frame established by the lender, the lender must follow up with the owner. The lender should remind the owner that the regulatory agreement requires a response no later than 30 days after receipt of the lender's report. The regulatory agreement also prohibits an owner from taking distributions if the owner has not responded to a report which: (1 requires corrective action; and (2) was received at least 30 days prior to the end of the fiscal period for which the surplus cash computation was made. Failure to respond could impede any future 2530 clearance.

b. Reviewing the Owner's Response. An acceptable response is one in which the corrective actions and target completion dates promised by the owner/agent are acceptable to the lender. These corrective actions and target completion dates do not need to be the same as the actions and target completion dates proposed by the lender. Being closer to the day-to-day operations of the project, the owner/agent may be more aware of the causes of, and possible remedies for, the project's problems. The proposed actions should be feasible, given the resources of the project, and should be capable of solving the project's problems in a timely manner. If the response is not acceptable to the lender, the lender should notify the owner. Unacceptable responses can generally be avoided if a close-out conference is conducted in accordance with the guidance provided in paragraph 6-6c.

c. Monitoring Implementation of Corrective Actions. The lender must monitor the completion of corrective actions. The type of monitoring may vary according to the owner/agent's past performance and the seriousness of the findings. When the agent has a good track record at this and other projects, major corrective actions will usually not be needed and management will usually be capable and responsive. In these instances, minimal monitoring may be justified. When management has a poor track record, close monitoring probably will be needed.

Monitoring could take several forms: periodic progress reports from the owner; on-site visits; owner submission of operating budgets and periodic reports comparing budgeted to actual expenses; or requesting the owner to provide verification that corrective actions have been implemented. Verification could include, but is not limited to, the following: an independent accountant's statement that accounting systems have been changed to comply with HUD requirements; revised procedures manuals incorporating procedural changes; copies of invoices for repair items; or before and after photos.

d. Use of Enforcement Tools. If the owner does not provide an acceptable response to a management review or physical inspection report or if the owner/agent fails to perform required corrective actions, the lender should review the enforcement tools available and determine which tools or mix of tools would most likely secure compliance. The tools most frequently used to secure compliance include: (1) denying an owner's requests for mortgage relief, reserve withdrawals, or rent increases; or (2) asking the HUD Field Office to temporarily deny or suspend the owner's or agent's participation in HUD programs.

CAUTION: When using enforcement tools, the lender and HUD staff must be careful not to aggravate existing problems or to create new ones by imposing harsher penalties than needed. The lender and HUD staff should assure that enforcement actions are directed at the party at fault -- i.e., the owner or the agent.

6-11. KEEPING HUD INFORMED.

a. The lender must send copies of all physical inspection reports and copies of any management review reports containing serious findings to the Loan Management Branch of the local HUD Field Office.

b. The lender should send these reports only after the deadline for owner response has passed. The lender should attach a copy of any owner response and the lender's evaluation of the response. The lender's evaluation must clearly indicate if the response changes the lender's original findings, recommendations or ratings.

c. The lender must also notify the HUD Field Office if the owner does not implement corrective actions on significant findings by the dates the lender required. The HUD Field Office will review the package and may request additional information from the lender. If the HUD Field Office and the lender both agree that the problems are serious, the Field Office will send the lender's report and related correspondence to the Previous Participation Committee at HUD Headquarters.

6-12. RECORDS RETENTION REQUIREMENTS. The lender must retain all reports of on-site inspections and reviews and all correspondence related to those reports for three years from the date the review was conducted.