



Housing Assistance Council

**RURAL HOUSING SERVICE'S  
SECTION 538  
GUARANTEED RURAL  
HOUSING PROGRAM:  
A GUIDE FOR DEVELOPERS**

\$5.00

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HAC, founded in 1971, is a nonprofit corporation which supports the development of rural low-income housing nationwide. HAC provides technical housing services, loans from a revolving fund, housing program and policy assistance, research and demonstration projects, and training and information services.

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## **I. INTRODUCTION**

### **A. What is the Section 538 Guaranteed Rural Rental Housing Program?**

The Section 538 Guaranteed Rural Rental Housing Program provides federal government guarantees for loans made by commercial lenders to developers of multifamily rental housing for low- and moderate-income tenants in rural areas. The U.S. Department of Agriculture (USDA) guarantees up to 90 percent of a loan made by a qualified lender.

Section 538, which was created by Congress in 1996, differs in some important ways from USDA's longstanding Section 515 Rural Rental Housing Program. Section 538 focuses on partnerships between USDA and qualified lenders, whereas Section 515 makes loans directly to nonprofit or for-profit rural housing developers. Section 538 is intended to provide decent, affordable rental housing for low- and moderate-income rural households with incomes up to 115 percent of area median income, higher than those served by Section 515. Income calculations for Section 538 tenants do not take into account the deductions permitted under Section 515. Units developed with Section 538 loans can be larger than those financed by Section 515. Either program can be used in conjunction with other subsidies.

### **B. About This Guide**

This guide is intended to provide basic information, particularly for nonprofit housing developers, about the Section 538 Guaranteed Rural Rental Housing Program. It provides a summary of the program and information about the application process, financing rates and terms, and construction, management, and servicing. Appendices include excerpts from the agency handbook for the program.

This guide is not intended to enable a reader to put together a loan application without using the agency handbook. Applicants should obtain and utilize the complete RHS/Rural Development instructions to the Section 538 program. (For ordering information, see Section II.F, page 6 below.)

HAC expects to update this guide periodically. Comments from those who have used the program, or tried to use it, are welcome.

### **C. Agency Names and Acronyms**

This guide refers to RHS (the agency responsible for the Section 538 program at the national level) and Rural Development (the designation for local, area, and state offices and staff administering the program). Both are parts of the U.S. Department of Agriculture. USDA's rural housing programs were formerly administered by the Farmers Home Administration (FmHA) and then by the Rural Housing and Community Development Service. FmHA has been eliminated through USDA restructuring. The FmHA farmer programs and about 30 percent of its staff were transferred to the Farm Service Agency (FSA), as part of a "one stop" center for farmers. The remaining FmHA programs were transferred to three small agencies: the Rural Business-Cooperative Service, the Rural Utilities Service and the Rural Housing

Service (originally named the Rural Housing and Community Development Service). Field staff and most program support staff for all three agencies became Rural Development staff. The latter are directly responsible to the Under Secretary of Agriculture for Rural Development.

Since RHS develops regulations and provides oversight to the program, this guide generally refers to RHS as the administering agency. Rural Development is referenced when state or local roles are involved. In some instances we use RHS/Rural Development.

## **II. RHS RURAL HOUSING PROGRAMS**

### **A. Using RHS Rural Housing Programs**

RHS rural housing programs are relatively easy to use. While land and housing development are complicated processes with complex governmental involvement, use of the RHS programs as financing vehicles should not add roadblocks to a project's success. They are very close to "do it yourself" programs for which the informed person or organization can apply without extensive use of expensive consultants.

There are five "basics" to understanding and properly using RHS housing programs:

1. Know what they do. Know the programs' purposes, as defined by law.
2. Know how they do it. Know the programs' processing procedures, as established by agency instructions, which are used by Rural Development and RHS loan processing and approval officials.
3. Know why they do it a particular way. Know how much authority Rural Development officials have. Variations from national instructions may occur because of state or local law or because of misinterpretation by individual officials.
4. Follow agency instructions. Provide what is asked for in the manner requested. Consult with the RHS/Rural Development office prior to developing a preapplication.
5. Obtain information on the current and future availability of funds.

Given a working knowledge in these basics, anyone can become reasonably proficient in using the RHS programs.

### **B. RHS Service Area**

RHS rural housing programs are available to eligible applicants (see Sections III.B and III.C, pages 7-9 below, regarding eligibility) in places considered to be "rural areas" under the agency's unique statutory definition of "rural." The definition is explained below, but the easiest way to know whether a particular place is "rural" is to consult the map on display in each Rural Development Field Office showing eligible rural areas within its jurisdiction. Political boundaries (boundaries of counties, incorporated towns, and the like) are not necessarily relevant.

"Rural" areas include open country that is not part of or associated with an urban area. Also included are any town, village, city or place, including places which are not part of or associated with an urban area but immediately adjacent to densely settled areas, with a population not in excess of 10,000 and rural in character. Areas with populations in excess of

10,000 but not in excess of 20,000 that are not contained within a Metropolitan Statistical Area (MSA), and have a serious lack of mortgage credit as determined by the Departments of Agriculture and Housing and Urban Development, are eligible.

Areas presently classified as rural or areas classified as rural prior to October 1, 1990, and areas determined not rural in character as a result of the 1990 decennial Census continue to be eligible if they have a population between 10,000 and 25,000, are rural in character, and have a serious lack of mortgage credit for low- and moderate-income families. (This provision may be changed – either to update it when data from the 2000 Census become available or, as proposed in Congress in 2000, to maintain eligibility based on the 1980 Census through 2010.)

A determination that open country or any town, village, city, or place is not part of or associated with an urban area must include a finding that any densely populated section of the area in question is separated from the densely populated section of any adjacent urban area by open spaces. These open spaces must be undeveloped, agricultural, or sparsely settled. These spaces may not be due to physical barriers, commercial or industrial developments, public parks, areas reserved for recreation, or similar open spaces. This determination should also consider such other factors as the existence of known plans for development within the near future (three to five years) of a substantial portion of the intervening land between the area in question and an urban area. The latest official Bureau of the Census data or more recent official population counts (U.S. Census of Population or other governmental official counts) are used in determining population.

Two or more towns, villages, cities, and places may have contiguous boundaries and still be considered separately provided they are not otherwise associated with each other and their densely populated areas are not contiguous. The Rural Development State Director is responsible for determining boundaries of rural areas and will issue an appropriate State Supplement to identify such areas by list and maps. Areas in excess of 10,000 population will be identified as “rural areas” in a State Supplement only after written authorization by the National Office.

When a change of designation from rural to nonrural is anticipated, the general public in the affected area is notified. If any area designation is changed from rural to nonrural, loans may be made there only in the following instances: loan requests received by Rural Development prior to the designation change may be processed; new conditional commitments may be issued and existing conditional commitments will be honored only in conjunction with the approval of loan requests received prior to the date the area was designated nonrural; credit sales and transfers with assumptions may be processed; and subsequent loans may be made on property in an area where the designation was changed from rural to nonrural after the initial loan was made where the subsequent loan will be used to make necessary repairs, or to pay equity in connection with an assumption and transfer of a Section 502 direct loan.

### **C. *RHS/Rural Development Organization***

RHS is a federal agency and is part of the Rural Development mission area within the U.S. Department of Agriculture. Most of its loan programs are processed directly by Rural



Development or RHS employees. Its organization is as follows:

1. The RHS National Office sets policy and develops regulations.
2. Rural Development Local Offices administer direct single-family programs in a state or multistate area. The Local Office director is titled “Community Development Manager.”
3. Rural Development Area Offices and/or State Offices receive, process and service applications for the Section 514/516 and 515 multifamily housing programs. Rural Development State Directors have been given discretion in their use of Area Offices, so Area Office use varies among states. The directors of Area Offices, where they exist, are titled “Rural Development Managers.”

**D. Locating Rural Development Area Offices**

Rural Development maintains approximately 260 Area Offices serving all rural areas of the United States, Puerto Rico, the Virgin Islands, and the Western Pacific Territories. To locate the Area Office serving your area:

1. Look for the local Rural Development office in the telephone book under U.S. Government, Department of Agriculture, Rural Development. If not under Rural Development, it may still be listed under the Farmers Home Administration or Rural Economic and Community Development. Local office staff can provide you with the address and telephone number of the Area Office serving your area.
2. Write or call the Rural Development State Office (see Appendix L or find your state at [http://www.rurdev.usda.gov/recd\\_map.html](http://www.rurdev.usda.gov/recd_map.html)).
3. Contact the National RHS Office for the current address of any Rural Development office in the nation. Write to Rural Housing Service, U.S. Department of Agriculture, 1400 Independence Ave., S.W., Stop 0781, Washington, DC 20250, or call 202-692-0067.

**E. Applicable Regulations**

The regulations for the Section 538 program are set out in Title 7, Part 3565 of the Code of Federal Regulations (7 CFR Part 3565). Additional essential guidelines are provided in a Rural Housing Service handbook, HB-1-3565, in which the regulations are included as Appendix 1. Other applicable regulations include instructions published in an annual Notice of Fund Availability and:

- ⊞ 7 CFR Part 11, Appeals
- ⊞ 1924-A, Development standards, architectural requirements, contracts
- ⊞ 1924-C, Subdivision and site criteria

- ⊞ 1930-C, Management, tenant occupancy, rental assistance
- ⊞ 1940-G, Environmental
- ⊞ 1944-L, Tenant grievance and appeal

These regulations can be found in Title 7 of the Code of Federal Regulations (CFR). For example, Instruction 1924-A is located in 7 CFR Part 1924, Subpart A. While the published CFR volumes may be convenient, they are updated annually only, and may not reflect key changes or revisions made during the interim. It is advisable to obtain copies of instructions from RHS/Rural Development offices, or recently updated CFR provisions from the World Wide Web at <http://www.access.gpo.gov/nara/cfr/index.html>.

Rural Development State Offices may issue relevant state instructions as well. State instructions are not discussed in this guide.

The RHS Administrator, or an official he/she designates, may make an exception to the regulations when the exception does not conflict with the law and failure to take action would adversely affect the government's interest or program objectives. Authorization for exceptions is found in Section 3565.13 of the regulations and paragraph 1.10 in HB-1-3565.

#### ***F. Ordering Instructions***

Public entities and nonprofit organizations can obtain single copies of a limited number of instructions free. Others can obtain a copy or copies for a copying charge. Instructions may be ordered from Rural Development Local, Area, or State Offices by requesting the instruction by name and number. If the needed instruction is unavailable from those offices, write to:

Rural Development  
Assistant Administrator  
Finance Office  
FC-313  
1520 Market Street  
St. Louis, MO 63103

1. Note you are a nonprofit or public organization.
2. Note the instruction number, such as 1944-D.
3. To subscribe for instruction changes, on a *calendar year basis*, send a check for \$40.00 payable to the "Treasury of The United States."

Most RHS/Rural Development regulations and handbooks, including HB-1-3565, can also be downloaded from the USDA web site at <http://rdinit.usda.gov/regs/>.

### **III. A DESCRIPTION OF THE GUARANTEED RURAL RENTAL HOUSING PROGRAM**

The Section 538 program provides government guarantees of loans made by private sector lenders (such as banks) for the development of affordable rural rental housing with at least five units. The program can be used to guarantee permanent financing, or a combination construction and permanent loan. It cannot be used for a loan that covers only construction.

A Section 538 guaranteed loan can be combined with other financing sources such as Low Income Housing Tax Credits, a HOME grant or loan, state or local assistance (including tax-exempt bond financing), or a second bank loan.

Proposed loans are selected for Section 538 guarantees based on criteria published each year in a Notice of Fund Availability in the *Federal Register*. In addition, in Section 3565.5(b) of the regulations RHS has established priority for projects “in smaller rural communities, in the most needy communities having the highest percentage of leveraging, having the lowest interest rate, having the highest ratio of 3-5 bedroom units to total units, or located in Empowerment Zones/Enterprise Communities or on tribal lands.”

As noted above, Section 538 differs in some important ways from USDA’s longstanding Section 515 Rural Rental Housing Program. Section 538 focuses on partnerships between USDA and qualified lenders, whereas Section 515 makes loans directly to nonprofit or for-profit rural housing developers. Section 538 is intended to provide decent, affordable rental housing for low- and moderate-income rural households with incomes up to 115 percent of area median income, higher than those served by Section 515. Income calculations for Section 538 tenants do not take into account the deductions permitted under Section 515. Units developed with Section 538 loans can be larger than those financed by Section 515, though the dollar amount of loan per unit is subject to limits established under Section 207(c)(3) of the National Housing Act, listed in Section 3.24 of HB-1-3565. Either program can be used in conjunction with other subsidies.

A developer using Section 538 can benefit from an alliance with its state housing finance agency (HFA). An HFA may provide additional low-cost financing from an existing state program or from issuing bonds. Generally a federal guarantee cannot be used in conjunction with tax-exempt bonds, but legislation passed in 1998 specifically allows tax-exempt bond financing to be used with a Section 538 guarantee. A state housing finance agency can issue either private activity bonds or Section 501(c)(3) bonds to generate low-rate financing. Four percent Low Income Housing Tax Credits can be added to the mix.

#### **A. RHS/Rural Development’s Role**

In addition to providing loan guarantees, the Rural Housing Service/Rural Development oversees the Section 538 program. Each lender must apply to RHS for approval to participate in the program. The agency conducts environmental reviews of sites for which guarantees are requested. Once a guarantee is issued, RHS monitors the lender to make sure program requirements are met.

## **B. Lenders' Role and Eligibility**

Lenders have the same responsibility for Section 538 loans as for loans that are not guaranteed. They underwrite (process and evaluate) applications and service loans (collect payments, communicate with borrowers, and the like). They pay fees to RHS (described below) and report periodically on outstanding loans.

Eligible lenders fall into two categories. First, any lender approved by Fannie Mae, Freddie Mac, or HUD/Federal Housing Administration, and currently active in their multifamily housing guaranteed lending programs, is eligible for Section 538. Second, state or local housing finance agencies, members of the Federal Home Loan Bank System, or other lenders can be eligible if they demonstrate to RHS that they have knowledge and experience with multifamily lending.

A lender that meets the eligibility requirements may apply to USDA for approval to participate in the program. For details on approval process and requirements, see Chapter 2 of HB-1-3565. A lender is considered "approved" when a loan note guarantee between the lender and RHS is executed. Approval requirements include an origination and servicing plan explaining in-house policies and procedures, and verification of the lender's track record. Approved lenders must agree to comply with RHS procedures, or must have agency permission to do things differently. Additional approvals are required for a lender to receive a guarantee of a combined construction and permanent loan.

A lender must provide a number of certifications for RHS, and its eligibility must be verified every year. In other words, this program requires lenders to do some paperwork. In exchange, approval enables the federal government to take the risk for some of their loans.

Other lenders may enter into an agent or broker relationship with an approved lender to participate in the program, or may participate in a loan. (Participation means that two or more lenders each provide part of the funds for the loan. In a participation arrangement under the Section 538 program, the lead lender must be RHS-approved.)

RD/RHS maintains a list of approved lenders.

In most cases RHS/RD will require the originating lender to service the loan and remain the mortgagee or secured party of record. A lender can sell a loan to Fannie Mae or Freddie Mac without prior approval from RHS, or to another entity only if it receives RHS approval first.

## **C. Borrower/Developer Eligibility**

To be eligible, a borrower must:

- ⊞ be a creditworthy single-asset entity, or have received prior written approval from RHS;
- ⊞ not be in default under any other agency housing program, or have performed well for six months in an approved workout plan;
- ⊞ be able to and intend to operate and maintain the project in accordance with program

- requirements;
- ⊞ be in legal and regulatory compliance with respect to any federal debt;
- ⊞ be a U.S. citizen or legal resident, a U.S.-owned corporation, or a limited liability corporation (LLC) or a partnership where the principals are U.S. citizens or permanent legal residents.

Types of eligible entities include:

- ⊞ public agencies;
- ⊞ Indian Tribes;
- ⊞ individuals;
- ⊞ general partnerships, if formed for a term at least equal to the loan term;
- ⊞ limited partnerships, with certain limitations;
- ⊞ for-profit corporations;
- ⊞ nonprofit corporations;
- ⊞ limited liability companies; and
- ⊞ trusts.

Lenders are responsible for ensuring that borrowers have the experience and capacity to properly develop and operate the property. They must review experience and financial resources and must verify that the borrower can construct or rehabilitate rental housing, provide a financially sound operation over the life of the loan, and be legally able to meet all aspects of rental housing development and operation. The lender will examine construction and rehabilitation experience, property management experience, and financial capability in detail. The lender must also be sure that each member of the development team, as well as the eventual property manager, has the appropriate abilities and experience.

The borrower must contribute initial operating capital equal to at least 2 percent of the loan amount.

The borrower and lender must sign a regulatory agreement containing the terms specified in Section 7.14 of HB 1-3565.

#### **D. Tenants**

To be eligible, tenants must have incomes at or under 115 percent of area median income at the time of initial occupancy. The property deed must contain a restriction enforcing the income limits. The income limit does not apply after initial occupancy – in other words, tenants need not leave the property if their incomes rise.

The borrower/developer must certify the incomes of all tenants at initial occupancy. RHS does not require recertification, but another lender may require it, and if a project receives Low Income Housing Tax Credits it will need to comply with the recertification requirements imposed by that program. Certification or recertification may be performed on any industry accepted form, unless there are no other subsidies attached to the property. In that situation,

RD Form 1944-8 must be used, but the borrower need only complete the portions of the form applicable to the Section 538 program (see Section 8.12B of HB-1-3565).

Income is defined to include **all** income for each adult member of the household. No adjustments to income are permitted.

RHS restricts rents in order to preserve affordability for the eligible income group. For each unit monthly rent, including utilities, may not exceed 1/12 of 30 percent of 115 percent of area median income, adjusted for family size. Appendix 9 of HB-1-3550 lists area median incomes. For an entire project, on an annual basis the average rent cannot exceed 30 percent of 100 percent of area median income, adjusted for family size.

Since utility costs are included in the rent caps, owners are required to establish an estimate of utility costs paid by tenants. Owners may use Exhibit A-6 to RD Instruction 1944-E for this purpose.

Tenant leases must be for 12 months or more, unless there is some special circumstance. Section 538 units may not be used for transient or migrant housing, nor as health facilities or student housing.

Borrowers and project managers must comply with fair housing laws. Any tenant or prospective tenant who believes s/he has been discriminated against because of age, race, color, religion, sex, marital or familial status, handicap, or national origin may file a complaint at any Rural Development office or any Department of Housing and Urban Development (HUD) office. Rural Development field office staff will help complainants to fill out forms and file complaints. HUD and USDA have established procedures for processing and investigating complaints.

Details about tenant occupancy requirements are provided in Chapter 8, Section 5 in HB-1-3565.

### **E. The Site**

To be eligible for Section 538, a property must be located in an area defined by RHS as rural (see Section II.B, pages 3-4 above) and must have at least five rental units. RHS prefers units to be on single or contiguous sites, but will accept scattered sites if the sites are all in one market area, managed under one management plan, and owned by one entity.

A site must also:

- ⊞ have necessary public facilities such as central water and sewer;
- ⊞ be conveniently located to services such as shopping, schools, medical, hospital, and pharmaceutical;
- ⊞ not be located in a less desirable area, i.e., located adjacent or close to train tracks, industrial areas, sites with environmental concerns, grain elevators and storage bins, older declining neighborhoods, gas stations and car lots;

- ⊞ meet all federal, state, and local codes, laws, ordinances, and zoning requirements;
- ⊞ have necessary infrastructure;
- ⊞ have soil compatible for the use and sufficient grading;
- ⊞ be free of undesirable physical characteristics such as costly rock condition, noise, and pollution;
- ⊞ have a density compatible with the neighborhood and market; and
- ⊞ be of sufficient size to accommodate the features needed and not to negatively impact overall cost.

The borrower must control the site at the time of loan closing and must have fully marketable title thereafter. RHS states that fee simple title is the only form of ownership accepted, but the agency does accept leases under the conditions listed below (also see paragraph 3.17B in HB-1-3565):

- ⊞ The lessor owns the land in fee simple.
- ⊞ There are no prior liens or unpaid taxes.
- ⊞ The loan does not exceed the market value of the property.
- ⊞ The unexpired lease term is at least 125 percent of the mortgage term.
- ⊞ The lease rent is no more than the rate for similar leases in the area.
- ⊞ The lease is recorded.
- ⊞ The lease is in writing and includes provisions that:
  - the lessor must approve all required improvements;
  - the lessor approves the right of the lender and the agency to foreclose and transfer the lease;
  - the lender and the agency have the right to bid at foreclosure sale or accept a deed in lieu of foreclosure;
  - the lender or the agency has right to sublet the property and sell the leasehold when acquired via foreclosure, deed in lieu of foreclosure, or abandonment;
  - the borrower can transfer the leasehold in the event of default or inability to continue;
  - the lessor must give the agency and the lender a notice of default and 60 days to cure the default.

The Rural Development State Office must approve the written lease agreement prior to loan closing, and approve any subsequent changes.

#### ***F. Eligible Uses of Funds***

The eligible uses of loan proceeds are detailed in Section 3565.205 of the regulation. In brief, they are:

- ⊞ new construction;
- ⊞ moderate or substantial rehabilitation (with some limitations), and acquisition when related to the rehabilitation;
- ⊞ acquisition of existing buildings for special needs (must be approved by RHS);
- ⊞ acquisition and improvement of land;

- ⊞ development of essential on- and off-site improvements;
- ⊞ development of related facilities;
- ⊞ on-site management and maintenance offices;
- ⊞ appliances;
- ⊞ parking development, landscaping, etc.;
- ⊞ limited commercial space costs, with specified limitations;
- ⊞ professional and application fees;
- ⊞ technical assistance and packaging fees to and by nonprofit entities;
- ⊞ board of director education fees for cooperatives;
- ⊞ interest on construction loans;
- ⊞ relocation assistance when applicable;
- ⊞ developers fees; and
- ⊞ refinancing applicant debt when authorized in advance to pay for eligible purposes prior to loan closing and approved by RHS.

Structures and sites must meet the standards in RD Instructions 1924-A and 1924-C.

Refinancing is not an authorized use of funds unless RHS grants an exception.

Projects must comply with applicable requirements in Section 504 of the Rehabilitation Act of 1973, the Fair Housing Act, the Americans with Disabilities Act, and other applicable statutes. For a list of statutes and a summary of Section 504 requirements, see Appendices D and E to this guide.

### **G. Environmental Requirements**

Rural Development and the guaranteed lender(s) include environmental risk management in their lending procedures in order to minimize negative impact on their security and establish a process to limit liability. Chapter 11 in HB-1-3565 outlines the agency's environmental review requirements for Section 538 loans. They are similar to those used for the Section 515 program.

Rural Development requires the lender to conduct due diligence in accordance with the current *ASTM Standard E-1527, Phase I Environmental Site Assessment* prescribed by the American Society for Testing and Materials. RHS/Rural Development then conducts an environmental review to demonstrate compliance with environmental requirements, based on the requirements in RD Instruction 1940-G (7 CFR Part 1940 Subpart G).

In practical terms, this means the applicant must provide the information necessary for the lender and RD/RHS to conduct their reviews. A description of any known environmental issues must be included in the response to the NOFA. Later, with submission of a full application, the applicant must include:

- ⊞ Form RD 1940-20;
- ⊞ *Phase I Environmental Site Assessment* report;
- ⊞ lender comments on any off-site conditions;



- ⊞ a land survey; and
- ⊞ FEMA Form 81-93, standard Flood Hazard Determination.

Guidance about the environmental information-gathering and review processes is available in two HAC publications: *Environmental Concerns in Choosing a Site for Rural Housing Development* and *FmHA [RHS] Environmental Regulations: A Guide for Rural Housing Applicants*.

#### **H. Loan Amounts and Terms**

Section 538 loan amounts are capped at maximum costs per unit established by HUD and available from HUD offices.

The lender may set the loan term, but the maximum is 40 years.

Generally RHS requires a first lien.

The lender determines whether the borrower has a prepayment option, but RHS will not pay any penalties for prepayment.

Interest rates must be fixed. Each year's NOFA will specify the maximum allowable interest rate.

For details, see Section 3565.208 in the regulation.

#### **I. Fees to RHS**

RHS charges fees to lenders receiving loan guarantees. For details, see Chapter 6 in HB-1-3565. Exhibit 6-1 lists the loan guarantee fees:

- ⊞ initial loan guarantee fee: 1% of the total guarantee amount, multiplied by the guarantee percentage;
- ⊞ annual fee: 0.5% of the outstanding principal and interest;
- ⊞ application fee, paid at the time the application is submitted: \$2,500;
- ⊞ extension fee, for extension of the commitment term: \$500;
- ⊞ reopening fee, after the commitment ends, at RHS's option: \$500 per reopening;
- ⊞ transfer fee if property is transferred from one owner to another: \$1,250.

#### **J. Extent of Guarantee**

The lender determines how much to lend. RHS requires the loan amount to be less than 90 percent of the total development cost or property value. Nonprofit borrowers and Indian tribes can borrow up to 97 percent of cost or value. The Section 538 program will guarantee a maximum of 90 percent of the unpaid principal and interest of the loan.

RHS will guarantee construction contracts to 90 percent of work in place if there are protective credit enhancements, such as:

- ⊠ surety or payment and performance bonding (RHS's preference);
- ⊠ an irrevocable letter of credit acceptable to RHS; or
- ⊠ lender's pledge of acceptable collateral.

RHS/RD may guarantee less than 90 percent, based on its evaluation of the loan. Once issued, a guarantee can be cancelled in the event of fraud, misrepresentation, abuse, negligence, or failure to adhere to the guarantee terms.

#### **K. Interest Credit (Subsidy)**

To help the Section 538 program serve low- and moderate-income tenants, the law requires that at least 20 percent of Section 538 loans made each year must receive interest credit subsidy sufficient to reduce the effective interest rate to the Applicable Federal Rate (AFR) defined in Section 42(I)(2)(D) of the Internal Revenue Code. The AFR is available at <http://ftp.fedworld.gov/pub/irs-utl/afrs.pdf> or in the *Wall Street Journal* on the third Wednesday of each month, labeled the "Long Term Monthly Rate."

According to HB-1-3565, this rate will reduce the interest rate by 100 to 200 basis points (1 to 2 percentage points). Lenders can receive interest credit on up to \$1.5 million for a single loan.

RHS selects which loans will be subsidized. All loan applications requesting interest credit subsidy are ranked along with other applications, as described below, and the highest ranked projects, representing 20 percent of all loans, are selected. Preference is given to applications for which interest credit would lower tenant rents or provide a higher level of tenant services than would otherwise be available.

## **IV. THE LOAN PROCESS**

### **A. Notice of Fund Availability and Application Process**

RHS publishes a Notice of Fund Availability (NOFA) in the *Federal Register* each year. It provides information on the amount of funds available, preliminary submission requirements, selection criteria, and deadlines for submission, usually 60 to 90 days after publication. Lenders (not borrowers) submit guarantee requests summarizing proposed projects. Each request includes a narrative explaining the lender's conclusions about the borrower, the property, and the loan. The agency scores and ranks those, then issues each successful lender a Notice to Proceed with Processing of its loan.

### **B. National Competition**

When Section 538 appropriations are \$100 million or less, competition for funding will be nationwide.

In fiscal years 1998, 1999, and 2000, all NOFA responses were submitted to and processed by the National Office. The handbook reserves the option of involving State Offices in future years, even delegating approval authority to them.

### **C. Allocation to the States**

When Section 538 appropriations exceed \$100 million, funds will be allocated to the states and territories by formula. The NOFA will provide addresses for Rural Development State Offices.

The allocation formula relies on each state's percentage of national:

- ⊞ rural population - a weight of 40;
- ⊞ number of rural households with incomes between 50 and 100 percent of area median income - a weight of 40; and
- ⊞ average cost per unit, based on limitations under Section 207(c) of the National Housing Act (see paragraph 3.24 of HB-1-3565) - a weight of 20.

Specific formula data for Section 538 allocations are found in Section 1940.560 of RD Instruction 1940-L.

### **D. Application Process**

The final application process is outlined below. Appendix A to this guide (Section 4.9 of HB-1-3565) lists the contents of an application. A timeline is provided in Appendix B to this guide.

The lender, responding to the NOFA, submits a request for scoring and ranking. The request includes:

- ⊞ a brief description of the project location;

- △ a description of the property and improvements:
  - lot size
  - number of units
  - building type
  - type of construction
  - preliminary drawings
  - bids for development;
- △ proposed schedule for development;
- △ total development cost;
- △ proposed rent structure;
- △ applicable area median income (see Appendix 9 to HB-1-3550 or check median incomes at <http://www.huduser.org/datasets/il.html>);
- △ evidence of site control;
- △ description of environmental issues that may affect the project;
- △ amount of loan to be guaranteed;
- △ proposed loan and proposed borrower's equity;
- △ proposed use of interest credit, if applicable;
- △ estimated development budget, including all financing sources and amounts, rates and terms;
- △ estimated loan to value ratio;
- △ proposed guarantee percentage (up to 90 percent);
- △ collateral - real estate and other security;
- △ borrower information:
  - name and type of borrower
  - contact person, address, phone and fax number, e-mail address
  - evidence that borrower and principals are not barred from federal programs or delinquent on federal debt
  - unaudited financial statement
  - statement about housing development experience;
- △ evidence that the lender is approved to participate in the program, or application for approval;
- △ information relating the application to the NOFA selection criteria; and
- △ commitment letter from the lender, subject only to an RHS guarantee.

If the lender is requesting interest credit, that information must be included in the application as well.

The lender underwrites – evaluates – a Section 538 loan just as it would underwrite any other. The lender is responsible for determining the value of the property, analyzing the cash flow proposed for the property, and reviewing projected operating costs. It must determine that the borrower and the property meet all program requirements. (See Appendix H to this guide for an example of RHS instructions to lenders for program compliance review.) It must evaluate the development team, the development costs, the proposed management, and the like.

RHS scores and ranks all complete and on-time applications for which the lender, the borrower, and the project meet threshold requirements. RHS will also consider factors such as

whether the developer has sufficient qualifications and experience, the project is feasible, the risk is reasonable for the market, and the loan is reasonable for the specific borrower. In addition, the agency will require the lender to have performed due diligence and considered the results in its appraisal. RHS/Rural Development must conduct an environmental review, a civil rights review, and a review of the applicant's Affirmative Fair Housing Marketing Plan.

The agency issues a letter of conditional commitment. The conditional commitment is valid for a stated time period, usually up to 24 months, and can be extended twice for 60 to 90 days each time. RHS/Rural Development will conduct a subsidy layering review of the information supplied by the lender. The loan guarantee fee of 1 percent of the note principal is due from the lender at closing of the loan note guarantee.

Before the guarantee is issued, the lender must execute Form RD 3565-3, Lender's Agreement, and submit a number of other forms (for a list, see Appendix I to this guide). For details, see paragraph 4.15 in HB-1-3565.

RHS's handbook states that the agency responds with a conditional commitment within 60 to 120 days of application, generally within 75 days.

### ***E. Ranking Criteria for Applications***

The basic ranking criteria for selection are found in Section 3565.5 of the published regulation. The criteria provide priorities for:

- ⊞ smaller rural communities;
- ⊞ the most needy communities with the highest percentage of leveraging;
- ⊞ applications with the lowest interest rates;
- ⊞ projects with the highest ratio of three- to five-bedroom units; and
- ⊞ projects located in Empowerment Zones or Enterprise Communities.

Additionally, RHS reserves the right in its sole discretion to set aside funds to meet important program goals.

Section 3565.5 lists five threshold criteria that must be met before an application can be ranked. These are:

- ⊞ The owner and development team must have the necessary qualifications and experience to carry out development, management, and ownership responsibilities, and not be under government suspension or investigation.
- ⊞ The proposed project must be in an eligible rural area.
- ⊞ The application must demonstrate readiness to proceed, including submission of a complete application.
- ⊞ The application must demonstrate market and financial feasibility. (See Appendices F and G to this guide.)
- ⊞ Evidence must show that the project's credit risk is reasonable.

The specific selection weights are provided in the annual NOFA. Those for FY 2000 are:

- (a) projects in the smallest rural communities 20 points  
(20 for the smallest, 19 next, and on down for the 20 smallest communities)
- (b) neediest communities measured by lowest median income 20 points  
(20 for the lowest, 19 next lowest and on down for the lowest 20 communities )
- (c) partnering and leveraging based on loan to value ratio

<u>Loan to Value Ratio (Percentage)</u>	<u>Points</u>
more than 75%	10
70-75%	15
Less than 70%	20

- (d) loans with interest rates less than the maximum allowable 250 basis points over the 30-year Treasury rate

<u>Interest Rates</u>	<u>Points</u>
more than 200 basis points	0
200 to 151 basis points, inclusive	5
150 to 100 basis points, inclusive	10
99 to 50 basis points, inclusive	15
less than 50 basis points	20

- (e) projects with the highest percentage of three- to five-bedroom units to total units 20 points  
(20 points for the highest percentage, 19 for the next highest, and on down for the 20 highest communities)
- (f) projects in a colonia, on tribal land, in an Empowerment Zone or Enterprise Community or high need community identified in a state consolidated plan or needs assessment 20 points
- (g) maximum amortization period without a balloon payment

<u>Amortization (years)</u>	<u>Points</u>
40	20
at least 35	15
at least 30	10
at least 20	5
less than 20	0

## **F. Appeals of Adverse Decisions**

Adverse decisions made by RHS/Rural Development to a lender or borrower (applicant) can be appealed through USDA's National Appeals Division (NAD). The regulations do not permit applicants/borrowers to appeal adverse decisions made by lenders.

Generally, the lender can appeal any adverse decision by the agency. Decisions that cannot be appealed include:

- ⊞ maximum interest rates set by RHS regulations, unless the appellant alleges an incorrect rate is used;
- ⊞ decisions made in accordance with the statute;
- ⊞ denials of credit due to lack of funds;
- ⊞ decisions made by the lender.

A basic overview of the appeals process is in Attachment 1-A to Chapter 1 of HB-1-3565, included as Appendix C to this guide.

Whenever the agency makes a decision that will adversely affect a lender it must notify the lender in writing of its right to appeal to a next-level supervisor, or to NAD. A request for review by a next-level supervisor must be filed within 15 days of the date of the adverse decision. An appeal to NAD must be filed within 30 days of the decision date.

Regulations for appeals to the USDA National Appeals Division are in 7 CFR Part 11, included as Appendix 4 in HB-1-3550. It is essential to read these regulations before beginning the appeal process. Also, prospective appellants should be aware that exercising appeal rights is subject to time limitations. For more information, see *A Guide to Appealing Rural Housing Service/Rural Development Decisions*, a HAC publication.

Appeals by tenants are made in accordance with RD Instruction 1944-L (7 CFR Part 1944 Subpart L).

## **V. CONSTRUCTION, MANAGEMENT, AND SERVICING**

The information provided here on construction, management, and servicing is not detailed, but is intended to provide some understanding of the scope of RHS requirements. The RHS handbook provides details.

### **A. Construction**

RHS monitors the process of constructing any multifamily property for which it has guaranteed a loan. The agency is more closely involved if it has guaranteed the construction loan. Even when it has guaranteed only the permanent loan, it has the right to be involved in construction-related meetings, attend inspections, and review documents. Details are in Chapter 5 of HB-1-3565.

The lender (not the agency) is responsible for ensuring that state codes are met, the construction team has appropriate experience, and the like.

### **B. Management**

Management rules are contained in Subpart H to Part 3565. Details are in Chapter 8 in HB-1-3565, which outlines specific requirements for:

- △ the role of the lender in property management;
- △ the responsibilities of the lender, including management plans;
- △ property manager;
- △ management agreement;
- △ occupancy requirements;
- △ tenant protection and grievance procedures.

Section 6 in Chapter 8 covers tenant protection and grievance procedures. It also refers to Part 1944 Subpart L, which covers the tenant appeal and grievance procedures. A timeline for the process is included as Appendix K to this guide.

### **C. Servicing**

Servicing rules are in Subpart I to Part 3565. Details are in Chapter 7 in HB-1-3565. The handbook states that the agency establishes servicing standards in order to protect three things: the value of the property, the tenants, and the government's interest. To this end, the developer and the lender are required to maintain and inspect the property, observe rent limits, establish a reserve account, and the like. The developer must report to the lender periodically, including audited annual financial statements. The lender must file regular reports to RHS. (For example, see Appendix J for audit requirements in connection with the guaranteed loan.)

Special servicing requirements are imposed for borrowers who are delinquent on loan payments or in default.



Through the Section 538 Guaranteed Rural Rental Housing Program, the federal Rural Housing Service/Rural Development guarantees loans for the development of multifamily rental housing for low-and moderate-income tenants in rural areas. This guide – part of the Housing Assistance Council’s popular Technical Series – explains the requirements for using the Section 538 program, and how to apply.

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