September 30, 2013

TO: State Directors
Rural Development

ATTN: Program Directors and Coordinators
Multi-Family Housing

FROM: Richard A. Davis ***(Signed by Richard A. Davis)***
Acting Administrator
Housing and Community Facilities Programs

SUBJECT: Underwriting Guidance for Transfer and MPR Multi-Family Housing Transactions

Purpose: The purpose of this Unnumbered Letter (UL) is to give further details about the key underwriting principles and guidelines the Agency has adopted for underwriting Transfer and MPR MFH transactions.

Agency underwriters will use the current underwriting template (UWT) available at: http://www.rurdev.usda.gov/rhs/mfh/MPR/MPRHome.htm to document their decisions. This UL supersedes previous Transfer and MPR underwriting guidance.

The Agency uses the term "underwriting" when referring to the process of financial feasibility determination. This process may entail asking questions such as:

- Is there a need for the project's affordability in its market area?
- Will the transaction work with less rental assistance (RA) or alternatively, with RA at the same level?
- Will the property be able to meet its projected up-front and long-term capital needs?
- Are the proposed rents adequate without being excessive?
- Will the level of vacancy and bad debt loss be at a level that is sustainable without being excessive?
- Is the operation & maintenance (O&M) expense level adequate to operate the property?
- Will all of the borrower's loan accounts be current after the transaction is closed?
- Is the capital investment sufficient to meet the needs of the property without being excessive?
- Does the underwriting address open physical findings identified in the Multi-Family Information System (MFIS)?

EXPIRATION DATE:
September 30, 2014

FILING INSTRUCTIONS:
Housing Programs

This UL focuses on these and other aspects of financial feasibility. This UL does not delve into aspects of the transaction process such as determining the suitability of the borrower, assessing environmental compliance or evaluating fair housing compliance.

In these times of dwindling resources and ever decreasing budgets, we must also focus on the transactional costs to the Government. Generally, affordable rental housing is dependent on tenant subsidies such as RA. The purpose of RA is to provide tenants with financial assistance to meet their monthly rental cost. When excess income remains after operating expenses, reserves and return to owner, the Agency must review the monthly rental cost in light of the amount of Agency provided RA. The Agency must analyze and review these transactions trying to minimize the cost to the Agency, including RA. The primary method of minimizing the amount of annual RA needed in a transaction is by minimizing future monthly rental costs. Allowing rents to rise specifically to address operating expenses and future repair needs may be appropriate; however, raising rents simply because they are below Conventional Rents for Comparable Units (CRCU) is not an acceptable practice.

Organization: Attachment A outlines the general underwriting principles, Attachment B outlines the most important underwriting factors for transfer transactions, and Attachment C for MPR transactions outlines the most important underwriting factors for MPR transactions.

The intent of this UL is to generate a broader understanding of transfer and MPR revitalization principles. The points of contact for this UL are the Multi-Family Housing Preservation and Direct Loan Division (MFH PDL) staff. Each state is assigned a MFH PDL staff member to assist with transfers and MPR transactions. The RD state office is responsible for underwriting these transactions; the MFH PDL staff is available to assist underwriters. If there are questions regarding the content of this UL, please contact your assigned MFH PDL staff member.

Attachment A
General Underwriting Principles

Key Agency Underwriting Concepts

A. **Major Multi-Family Housing (MFH) Goal.** The Agency's major goal for the MFH portfolio, including Rural Rental Housing and Farm Labor Housing properties, is to preserve needed properties, using long-term Restrictive-Use Provisions (RUP) and/or Restrictive-Use Covenants (RUC), under sustainable rent and financing structures. A sustainable rent and financing structure is one that can be expected to meet the property's long term needs, without additional Agency or third-party funding. *The Agency's objective of preserving these properties should be attained with a minimal cost to the Government.*

B. **Revitalization.** The Agency uses the term 'revitalization' to mean the process by which a non-sustainable property is made sustainable. A revitalized property is sustainable for the long term considering its current rent and financing structure, often without the need for unusually high rent increases or new Agency loans, and has long-term affordability protection under a RUP or RUC.

C. **The Comprehensive Property Assessment (CPA) Study.** Revitalization had its roots in the CPA Study whose final report was issued in November 2004. The good news from the CPA Study was that the portfolio was in generally good physical condition, with generally affordable and modest rents. The bad news was that the CPA Study concluded that current rent structures and financing structures were not adequate for long-term sustainability. It also concluded that solving the RRH sustainability problem in the traditional way (with rent increases, additional Rental Assistance (RA), and supplemental loans) would be prohibitively expensive from a Federal budget standpoint. The CPA Study did stipulate that debt deferral, available third-party funding such as Low Income Housing Tax Credits (LIHTC) and modest additional Agency funding was an economically feasible financing alternative for revitalization.

D. **Budget Pressure, Particularly on RA.** Since the CPA Study was completed, the Agency has come under budget pressure because outlays for RA have grown. This budget pressure to minimize RA requires that rent increases be considered only as a last resort. The most cost effective method of revitalizing properties is through capital funding. If rent increases are needed, however, these increases should not exceed the general rate of inflation.

E. **Multi-Family Housing Preservation & Revitalization (MPR) Demonstration Program.** Starting with Fiscal Year (FY) 2005, Congress authorized the MPR demonstration programs annually. As part of the demonstration, the Agency underwriting incorporated the finance tools recommended by the CPA Study. These tools include debt deferral, zero percent loans, soft second loans and grants.

F. **Working with Third-Party Funders.** Many of the transactions underwritten by the Agency involve third-party funding. The primary source of third-party funding has come from the Low Income Housing Tax Credits (LIHTC) program. All Agency MFH Program Directors and lead underwriters should cultivate a strong working relationship with the agency that administers the LIHTC program in their State. When possible an understanding or written agreement should be reached on how our agencies can share underwriting and subsidy layering review information to help assure the most effective

use of public resources when combining funding from both programs. The goal of that agreement should be to minimize the duplicative review process. One way to eliminate the duplicative nature with multiple regulators is to agree to accept analysis or reviews by another regulator. More specifically the agreement may include common elements within the underwriting process. Examples include agreeing that sales prices for transfers cannot exceed appraised values, appropriate returns to owner, and agreed upon property reserve levels.

G. **Clauses that survive closing**. Clauses or phrases in the conditional commitment (MPR transactions) or the concurrence/authorization memo (transfer transactions) often will survive the transaction closing. Those conditions or commitments must be entered into MFIS to document that the commitments have been, or will be, met during the term of the loan or until a new servicing action occurs.

Key Underwriting Principles; the underwriting principles discussed in this UL can be grouped into the following general headings.

1. **New 20 + year Restrictive Use Agreement.** As a general rule, a new Restrictive Use Provision (RUP) or Restrictive Use Covenant (RUC) is required of any significant Agency or non-Agency investment in a property.

    a. **For MPR transactions,** a separate, stand alone RUC is required and is generally recorded in a first lien position. The term of the RUC is set out in the MPR's Notice of Funding Availability (NOFA). States are required to use the MPR documents available on the Agency MPR website. https://mfhdemoteam.sc.egov.usda.gov/MPR/default.aspx

    b. **For Transfer transactions,** RUPs must be inserted in the legal documents required by the specific transaction (mortgage or deed of trust, warranty deed, release documents, etc.) and may also include a separate RUC approved by the Office of General Counsel (OGC) that is outside the loan documents designed to survive foreclosure or prepayment. **Refer to 7 CFR 3560, 3560.72 (a) (2).**

2. **Modest and Affordable Rents.** MFH transactions result in sustainable rents that are as low as possible, rents that are at or below CRCU and rents that are affordable to residents in that market area. Sustainable rents should be reasonable and not be set artificially high (at or just below CRCU) because RA is available to support the cost. Rents should be established based on the cash flow of the operating budget.

3. **Sustainable Operating Budget.** The Agency's underwriting generally provides an operating cushion in the property's operating budget so that normal year to year variations in revenues and expenses can be absorbed from operations rather than the capital reserve account.

4. **Minimum Annual Reserve Balance Benchmark.** The Agency requires the project reserve account to be sized to show that funds will be available to meet the physical needs of the property over the 20-year approved Comprehensive Needs Assessment (CNA). The underwriter will adjust the annual deposit to allow for a reasonable positive ending balance for each of the 20 years as adjusted for inflation.

5. **Capital Operating Budget.** A reasonable amount may be allowed on line 9, Capital Operating Budget, to address tenant turnover costs provided these costs are not reflected in other budget lines or included in the CNA. The budgeted amount for tenant turnovers should be supported by the project's management plan.

6. **Sustainable Reserve Account Level on CNA.** In all transactions the reserve should be sized to show that 100 percent of the CNA needs can be met from the reserve account in the year the need is projected to occur without needing either additional funding from the Agency or operational support such as rent increases.

Attachment B
Transfer Underwriting Principles

This section discusses the underwriting principles for transfer transactions. For transfers participating in the MPR Program, refer to Attachment C for additional underwriting guidance.

A. **Overview.** After a transfer and once revitalized, all properties should be financially sustainable.

1. **Conventional Rents for Comparable Units (CRCU).** Any third-party debt service for equity or rehabilitation, and any increase in Return to Owner (RTO) must be determined using CRCU after providing for sustainable levels of rent loss, O&M expenses and reserves. CRCU must be determined using the Agency-approved method in HB-1-3560, Chapter 3, Section 3.20 and HB-3-3560, Chapter 7, Section 7.7B.

2. **Agency Funds.** If equity pay-out or increased RTO are being proposed as part of a transfer, no new direct Agency funds may be proposed as part of the transfer portion of the transaction.

3. **For Additional Information.** Transfer underwriting is discussed in detail in HB-3-3560, Chapter 7.

4. **Borrowers with Daily Interest Accrual System (DIAS) accounts.** Except for certain FLH loans, borrower accounts, must convert to the Predetermined Amortization Schedule System (PASS) each time a loan servicing action takes place (e.g. re-amortizations, equity incentive loans or any project transfers). Reminder: A "same rates and terms RRH transfer" will convert the project to the PASS system.

B. **Key Parties to a Transfer.** Key parties are the Seller, the Purchaser, the Agency (on behalf of the tenants and as mortgagor) and any third-party funders (other lenders, tax credit agencies, etc.)

1. N**eeds of the Agency.** To maintain the value of the project as security for the Agency's loans, the Agency imposes these requirements on all transfers:

   a. **Adequate Funding for Up-Front Capital Needs.** There must be adequate funds to address repairs needed immediately. These capital needs may include up-front rehabilitation that is being paid with third-party funds.

   b**. Adequate Funding for 20-Year Capital Needs.** The ongoing reserve balance must be sufficient to meet the identified capital needs of the property over the next 20 years in accordance with the CNA. The CNA must be provided as part of the documentation for the approval of a proposed transfer.

   c**. Minimum Annual Reserve Balance Benchmark,** the underwriter shall size the annual deposit to allow for a positive ending balance for each of the 20 years. When feasible, the reserve account shall be sized to show 100 percent of the CNA needs being met over 20 years. Proposed transfers

that are unable to meet this criterion may be approved with Agency concurrence in accordance with 7.29H (HB 3-3560).

d**. Adequate Operations &Maintenance (O&M) Expenses.** The O&M expenses underwritten for the transfer must be adequate to operate the project in a typical operating year and should generally be at or above historical levels. However, projects requiring major rehabilitation may reflect changes in the maintenance cost whenever: (a) historical expenses have been elevated because of the properties' previously poor physical condition and (b) the proposed reduced cost will be adequate on a long-term basis and will be consistent with other projects of similar size and characteristics in the same cost areas. Underwriters should utilize the Hyperion report to compare similar and same-market area properties' expenses. Underwriters should compare the operating income and expense data used by other funding sources involved with the proposed transfer and discuss any differences early in the process to avoid conflicting underwriting standards that may jeopardize the potential success of the project.

e**. For More Information,** HB-3-3560, Chapter 7 addresses the Agency's requirements for transfer transactions.

2. **Needs of Seller and Purchaser.** The seller typically is seeking to receive an equity payment. The purchaser typically is seeking a viable property plus a developer fee or other compensation for putting the transaction together. (Note: Developer fees may be paid from tax credit equity or Section 538 GRRH loan proceeds, but not from other Rural Development sources such as MPR tools, Section 515 loan funds or any other 3rd party loan sources that would require debt service.) Any Deferred Developer Fee (DDF) may only be paid from the RTO that is approved, earned and distributed. Underwriters and applicants should consider using the Transfer Analysis Tool in conjunction with the provisions of HB-3-3560, Chapter 7, to initiate dialogue with all of the parties involved with the transfer and discuss requirements specified in the Rural Development Handbooks. The Transfer Analysis Tool may be found on the Rural Development website at: http://www.rurdev.usda.gov/HMF_MPR.html. This part of the process is a balancing act and is crucial to the successful completion of every transfer transaction.

3. **Existing and Future RUP/RUC.** The Restricted Use Provisions and the Restricted Use Covenants are essential for providing long-term affordability in transfer transactions. Whenever the Agency approves a new transfer, extending the existing RUP/RUC is required.

4. **Working with Third-Party Funders.** In most instances there are outside funds provided through 9 percent tax credits, tax exempt bonds in association with 4 percent tax credits, and/or other third-party funds. It is essential that the Agency's representative is involved during the negotiation stage between the potential purchaser and the seller to protect the interests of the Agency. It is important for the Agency's representative to ensure the Agency's regulatory requirements are met through this transaction. Third-party funders must be provided with the Agency's requirements.

5. **Post Transfer RUP or RUC.** In general, a new 30-year restriction is required for new Section 515 loans. A new 20-year restriction is required otherwise. For

FLH, a new 33-year restriction is required. It is recommended that the Agency representative consult with the Office of General Counsel in making the post transfer RUP or RUC determination. For more information:

a. 7 CFR §3560.406 (g) and the reference §3560.662.

b. HB-3-3560, Chapter 7, Paragraph 7-31 D.

C. **Key Underwriting Determinations for Transfer Transactions.** The most important financial feasibility determinations for transfer transactions include the following, each of which are discussed in more detail below:

1. **CRCU.** What are the true market rents this property could command in the local market if there were no USDA restrictions? CRCU must be determined in the underwriting of each transfer transaction (see HB-3, Chapter 7, Paragraph 7.7B).

   a. **When an Appraisal is required.** A market value appraisal is required each time an equity pay-out is proposed. The market value appraisal is to assist the underwriter in determining the maximum equity payment the seller may receive (other appraisal values may be considered transaction dependent). For more information regarding appraisals see HB-1-3560, Chapter 7, Section 2.

   b. **Rent Comparability Study (RCS).** When an appraisal is not required (same terms transfer) a RCS may be used to determine CRCU. However, the RCS must follow the statement of work in HUD's Section 8 Renewal Guide.

   c. **Other Options for Determining CRCU.** Other options to determine CRCU for certain transfer transactions not involving equity pay-outs include a borrower provided third-party market study or a third-party market survey.

For more information, review HB-1-3560, Chapter 3, Section 3.2 or HB-3-3560, Chapter 7, Section 7.7B.

2. **Transfer (New Rates and/or Terms).** Generally, it will be in the best interest of both the Agency and the tenants to transfer existing loans on new terms as part of the transfer transaction. The new terms transfer may include a new note interest rate if the current note rate of interest is higher than the current interest rate in effect at the time of approval or closing, whichever is less. Transfers on new terms (amortized over a longer period with or without a lower note rate of interest) often will help to make a proposed transfer transaction feasible for the seller, the purchaser and the Agency.

   a. Generally, transfers on new terms will be desired by the seller and purchaser, because it typically results in an additional cash flow within CRCU rents for additional loan debt service and/or increased RTO.

   b. The purchaser should always consult appropriate outside tax counsel when using tax credits.

For more information, see HB-3-3560, Chapter 7, Paragraph 7-24B and 7 CFR 3560.455 (b).

3. **Maximum Equity Loan Debt Service.** The equity loan amount is based on the maximum or the allowable monthly payment (using the lower of the proposed rents or CRCU rents) as determined in the underwriting template (UWT) after:

a) Subtracting a reasonable allowance for rent loss,
b) Adding a reasonable estimate for other income (e.g., laundry),
c) Subtracting adequate O&M expenses,
d) Subtracting an adequate Reserve deposit,
e) Subtracting debt service on pre-transfer debt (using prevailing rate and term),
f) Subtracting the current owner's RTO, and
g) Subtracting the operating cushion.

a. **Maximum Loan.** Once the maximum debt service is identified, and once the market interest rate and loan term for third-party equity loans is determined, the UWT will calculate the maximum equity loan size.

b. **Accounts Payable.** Any accounts payable must be paid by the seller prior to closing.

For more information, refer to HB-3-3560, Chapter 7, Paragraphs 7.8B and 7.8C, and the Transfer Analysis page of the UWT.

4. **Sales Price.**

a. **Sales Price for Real Estate,** if the current sales contract includes an equity payment to the seller and the transaction includes a third-party loan, then the amount of the equity cannot exceed the maximum amount discussed above.

NOTE: Rural Development does not restrict the sales price on transactions that do not affect the basic rents and are (i) funded solely with LIHTC equity, or (ii) funded with the purchaser's own funds or other 'soft dollars'; and (iii) are not dependent on project income for repayment.

In all other situations, the sales price is the lower of the appraised value or the amount of assumed debt plus the third-party equity loan that fits within CRCU. Underwriters should carefully review the sales contract to fully understand the terms and conditions to which the buyer and seller have agreed. If third-party funding sources are being considered as part of the transaction, care should be taken to ensure all parties to the transaction (including any third-party funding sources) are using the same conditions, assets being conveyed and any other terms before underwriting the transaction. If anything is not clearly understood, the buyer/seller should provide appropriate clarification to allow accurate data input into the UWT.

b. **Sales Price for Reserve Balance.** The Agency allows the seller to 'sell' the reserve balance to the purchaser, but requires the reserve account funds themselves to pass to the purchaser as part of the transaction. As a practical matter, the purchaser must come up with soft funds in order to pay the seller for the reserve balance. Generally, the sales contract must note if the reserves are included (state law may restrict what is included in a real estate contract) in the total sales price (over and above the sales price for the real estate).

c. **Under-Funded or Delinquent Reserves.** If the reserve balance is below the required amount, the seller or purchaser must restore the required balance as a condition of transfer. For additional information, see 7 CFR 3560.406 (c) 2.

d. **Excess Reserves.** The Agency makes an exception for reserve balances that exceed the required balance. These 'excess reserve funds' may be released to the seller, as part of an equity pay-out, directly from the reserve account, with Agency approval that all capital needs will be met. This is an exception to the general rule that reserve funds must pass intact to the purchaser. For additional information, refer to the Underwriting Template and Transfer Input sheet.

e. **Inadequate Reserves.** In typical transfers, the reserve is at or above the required amount (required deposits less authorized withdrawals), but does not have sufficient funds to meet any immediate needs and provide an appropriate starting balance for meeting the 20-year CNA needs. In this situation, the transfer transaction must include sufficient sources of non-Agency funds to supplement the inadequate reserve balance. When determining the needed additional reserve deposit at the time of transfer (the IDRR), the underwriter must also consider the following:

1) **Gap Account.** If some of the reserve funding is earmarked for an insurance deductible, subtract that amount from the reserve for underwriting purposes.

2) **Authorized Reserve Requests.** If the seller has been authorized to withdraw funds from the reserve account, the underwriter must determine if those purposes are part of the needs identified in the CNA and adjust the amount as appropriate.

5. **New RTO.** The following describes the circumstances that warrant a new RTO that is higher than the pre-transfer RTO.

a. **Purchaser is a Non-Profit.** In situations where the purchaser is a non-profit, no RTO is allowed. An asset management fee, however, may be allowed. The asset management fee is limited to a maximum amount, and must be accompanied by documentation. The fee is not a fixed amount. For more information, refer to 7 CFR 3560.303 (b) (1) (ii). Generally the Agency considers a Limited Partnership or Limited Liability Company (LLC) as a for-profit entity. However, if the general partner/managing member is recognized as a non-profit organization by the state corporations commission (or equivalent state agency), the Agency may treat the entity as a non-profit and thus not eligible for RTO.

b. **Purchaser is a For-Profit (*new*).** Per §3560.406 (d) (14), a limited profit Rural Rental Housing transferee's initial investment and return on investment will remain the same as that originally provided to the transferor unless: (ii) The transferee contributes additional funds for repair or rehabilitation and the Agency agrees to recognize a higher initial investment. When the purchaser is a for-profit entity, the Agency agrees to recognize the deferred developer's fee and/or the transferee's additional cash contribution (*tax credit proceeds are not considered a cash contribution*) for repair or rehabilitation as the initial investment from which the RTO will be calculated.

An example of how to calculate the RTO: Deferred Developer fee of $300,000 used in the deal X 8 percent = potential increase to ROI of $24,000, then 300,000/$24,000 = 12.5 years for repayment.

Tax credit equity used for hard cost of construction is no longer an eligible basis for an increased RTO

The UWT includes a Transfer Sources & Uses Input Sheet. This sheet is used to allocate costs between acquisition (paying the sales price), repairs (hard costs of construction defined as "bricks and mortar"), and soft or other costs (transaction costs). The underwriters should obtain and review the applications as well as the award letters for all third-party funders to understand how the funds from each source will be used in the transaction. For more information, see the UWT, Transfer S&U Input Sheet, and your Team Leader.

6.   **New rents.** The rents should be the minimum needed for the property to cash flow at the basic rents. The UWT calculates the new post-transfer basic rents.

Note: Underwriters need to be aware of any rent restrictions imposed by third-party funders. If the third-party funders have rent restrictions lower than CRCU, the transaction must be underwritten at the lesser of CRCU or the rent restrictions imposed by the third-party funder.

Attachment C

Underwriting Principles for Multifamily Housing Preservation and Revitalization Demonstration (MPR) Transactions

This section discusses underwriting principles for MPR transactions. MPR transactions involving transfers generally follow a two-step process. In the first step, as discussed in HB-3-3560, Chapter 7, transfers are underwritten to satisfy all of the transfer principles discussed in "Attachment B" to establish the maximum RTO, to determine the maximum equity payment and to size the funding for the reserve account. After the transfer is underwritten and approved by MPDL, the second step in the transaction is the underwriting of the MPR. The MPR transaction is underwritten to meet the following principles and any other requirements stipulated in the NOFA to which the MPR submission responded.

A. **Underwriting Resources in Addition to this UL.** The Rural Development UWT contains instructions and tips on each page. In addition, Rural Development publishes a set of instructions for the UWT, designed to help first-time users understand the UWT and how to use it. The UWT and instructions are available at http://www.rurdev.usda.gov/HMF_MPR.html (drill down request UWT, preliminary analysis transfer and MPR tools, etc.)

B. **Key Underwriting Determinations.** The key financial feasibility determinations for MPR transactions include the following:

1. **Combined Vacancy/Bad Debt Factor.** Budget an appropriate allowance for vacancy/bad debt. This combined percentage should be set at a level the property cannot reasonably exceed. The appropriate factor is one that will be adequate to absorb normal year to year fluctuations in occupancy and in local market conditions. Generally, the combined rent loss and bad debt factor should be the greater of (a) 5.0 percent or (b) 2.0 percent above recent actual rent loss. However, in no case should the combined vacancy and rent loss exceed the limit stated in HB-2-3560 Chapter 4 Section 4.26 B.

    a) **Consider the Impact of any Rent Increase.** The marketability of the property to tenants will be affected by any proposed changes in basic rents.

    b) **Consider Relationship to CRCU.** If the proposed basic rents are well below CRCU, typically this borrower should be able to market the property to eligible applicants with low or minimal rent loss. If the proposed basic rents approach CRCU levels, difficulties in marketing the property to eligible applicants without a subsidy can be expected.

    c) **Temporary Rent Loss during Rehabilitation and Lease-Up.** If the MPR transaction includes significant repairs, relocation of residents, may be necessary. Additional sources of funds may be included to cover temporary losses of revenue during the repair and lease-up period. If the general operating account does not have enough funds to meet the normal expenses during the repair period, then an operating deficit account can be implemented using the operating deficit escrow tab in the UWT. If tenants must be relocated during the rehab period, relocation costs may be included in the MPR funding. The applicant must provide a plan to

document the proposed relocation costs. This will be documented in the narrative required for all MPR transactions.

2. **Sustainable O&M Expenses.** Underwritten O&M expenses must be adequate to meet project needs while absorbing normal variations in expense levels without being excessive. Documentation should be provided showing that the planned expenses are reasonable and necessary to operate the project in a manner consistent with the objectives of the program. Underwriters need to be cognizant of the timeframes involved; underwriting, closing and rehab completion all contribute to a delay in a timely budget implementation. Realistic budgets should reflect these factors.

   a) **Consider Recent Actual Expenses and Budgeted Expenses.** Normally the underwritten amount for each subtotal for any operating expense category O&M line item (Form 3560-7, Part II) should be the greater of (a) the current approved budget, (b) the most recent or actual results adjusted for inflation, or (c) the prior year actual results adjusted for inflation. If any subtotal amount exceeds the acceptable threshold set forth in HB 2, chapter 4, adequate documentation must be provided.

   b) **Consider Effects of the MPR Transaction.** For example, if recent actual expenses include high HVAC repair costs and the MPR transaction includes replacement of HVAC units, the underwritten amount for HVAC costs may be reduced to a typical level which may be below the unusual levels incurred recently. Similarly, if the MPR transaction involves adding air conditioning, the underwritten amount for HVAC repair costs should be higher than historical levels. The Agency has the Hyperion report that may be used to compare expense items among all Agency properties.

   c) **Consider Similar Properties.** If proposed O&M expenses are materially lower than those of similar properties, there is a risk that the property might not be viable if a change in management is required. Similarly, if proposed O&M expenses are materially higher than those of similar properties, that is an indication that management is not efficient and should be considered for replacement.

   d) **Consider the CNA.** Form 3560-7, Part II Line 9 (annual capital budget-Operating) will normally be zero or a minimal amount in an MPR transaction because the items normally included in this line will be included in the CNA (and funded from the Reserve post MPR).

3. **MPR Operating Cushion.** An allowance shall be built into the basic rents over and above the allowed RTO, which allows the property to absorb normal income and expense fluctuations without needing to dip into the Reserve.

   a) **Greater than Normal Cushion.** The level of cushion should be increased if the project is especially vulnerable to revenue and expense fluctuations.

   b) **Lower than Normal Cushion.** The level of cushion may be decreased if the property has an especially strong history of operational stability, low vacancy and a strong operating cash balance.

c) **Cushions and RD Form 3560-7.** In the post MPR proposed operating budget, the cushion should appear on Part I, Line 30, NET CASH (DEFICIT).

d) **MPR Cash Flow**. The Agency underwrites all MPR transactions to allow for a positive cash balance on line 30 of the Operating Budget. The maximum cash balance on line 30 is 10 percent of the proposed Operation and Maintenance (O&M) expenses. In determining what reasonable cash balance is for the property, the underwriter will consider the balance in the General Operating Account (GOA). If the GOA has between 15 percent – 20 percent of the O&M, the cash balance should not exceed 5 percent. If the GOA has a balance of 10 percent or less of O&M, 10 percent may be reasonable.

4. **Accounts Payable.** If the property has outstanding accounts payable (over 30 days old), the underwriter should include a solution in the proposed transaction narrative page. If any tax escrow or insurance escrow accounts are under-funded, the underwriter should take the under-funding into account because under-funded escrows are additional accounts payables. Solutions could include payment of the excess payables by the borrower.

5. **Sustainable Funding for Capital Needs.** The reserve account is key to ensuring a physically-viable property. Determine the appropriate mix of funding to address long-term capital needs identified in the CNA. After MPR, the property should be able to meet 100 percent of its expected long-term capital needs from the reserve, without requiring either operational resources such as rent increases above the rate of inflation or new funding such as supplemental loans.

a) **Agency Review of CNA.** Agency review and acceptance of the CNA must be completed prior to beginning the capital needs portion of the underwriting process. Agency instructions for CNA reviews may be found in the CNA UL at http://www.rurdev.usda.gov/RD_UnnumberedList.html. Any adjustments made to the CNA by the Agency during the underwriting process will be made in the UWT and may affect underwriting. Underwriters do not make any changes to the accepted CNA, which remains in the Agency's files. Underwriters should recognize that the CNA (and the Agency's CNA review) and any agreed upon scope of rehab may call for changes in the O&M expenses. Adjustments to the underwriter's CNA located in the UWT may be made by the underwriter, but must be documented in the narrative.

b) **Sources of Funding.** Sources of funding include the existing Reserve balance, any IDRR which may be required to be made at the MPR closing, future Reserve deposits and interest earnings.

c) **Inflation Assumptions.** The Agency's instructions for CNAs ask the CNA Provider to assume that unit costs (for example, refrigerators and roof replacements) will increase at 3.0 percent per year. For MPR underwriting, the Agency asks underwriters to assume that unit costs will increase at the rate of 3.0 percent each year and the annual reserve deposit amount will increase at the rate of inflation assumed in the President's budget in effect for the year in which the transaction is approved. This

rate is set out in the UWT. Refer to the UWT, Cap Needs sheet and the program variables sheet.

d) **Mix of IDRR and ADRR.** A property's 20-year capital needs can be met through many different combinations of IDRR and annual deposit to reserves (ADRR). Underwriters should select a combination that is appropriate given the particular transaction's characteristics, including:

   1) **Impact on Rents and RA.** Use the combination that results in the lowest level of basic rents and minimizes RA costs.
   2) **Likely Future Needs.** Generally, the ADRR should reflect the most likely long-term level of capital needs, so the property will be adequately positioned for sustainability following the 20-year analysis period.
   3) **Availability of Funds.** A strategy that requires a significant IDRR can be adopted only if sources of funds are available to make the IDRR and if it is more cost effective to utilize those funds than to utilize an alternative strategy that does not require an IDRR. Generally, this strategy is preferred when significant equity is involved.
   4) **Annual Reserve Balances.** If annual projected reserve balances are greater than $500.00/unit, the IDRR should be lowered and the ADRR should be increased.
   5) **For Any Transaction Involving Third-Party Funding**. In these cases, the underwriter should discuss Rural Development reserve funding requirements as well as reserve uses early in the process to avoid misunderstandings and assure Rural Development program requirements are being followed throughout the term of the loan.

e) **Impact on Rents and RA.** Some MPR transactions require significant increase in basic rents to ensure the property is financially stable. Basic rents should not increase by more than is needed in any single year and the total rent increase needed should not exceed 30 percent. A rent increase may be phased in over a period not to exceed three years. It is preferred that any rent increase be the minimum required for the property to cash flow.

f) **Viable Rents.** Basic rents must be set at the rate to support the property's long-term viability but low enough to be affordable to tenants and to be competitive in the local rental market.

g) **Rent Decreases.** Generally, rent decreases are implemented immediately and are not phased in.

6. **Impact on Rents and RA.** In approving MPR transactions, the Agency carefully considers the impact on RA costs and prefers approaches that minimize RA cost.

7. **Mix of MPR tools.** The MPR Demonstration program includes a variety of financial tools for making properties sustainable. *The underwriter should propose the best mix of tools for the specific property taking into account the factors discussed below:*

a. **List of MPR Tools.** The following is a brief description of the MPR tools that have been authorized by Congress for the MPR Demonstration program (FY 2005 through FY 2012).

1) **Debt Deferral.** Generally, MPR transactions should utilize a debt deferral to reduce debt service. Debt deferral allows basic rents that previously funded debt service to be used for increased reserve deposits or a reduction in rents.

2) **Supplemental Section 515 Loans.** MPR transactions may include supplemental 515 funding. This funding is typically used to meet capital needs if it will result in a debt service that keeps basic rents at or below CRCU and that otherwise remain otherwise affordable.

3) **Grant.** A small amount of grant funding is available to non-profit owners and may only be used to fund immediate health and safety issues identified in the CNA. *Generally, underwriters should propose this funding for eligible transactions when funds are available and for those transactions that cannot afford additional debt service without raising rents over CRCU or that would cause a greater negative impact on current tenants.*

4) **Soft Second Loans.** Soft second loans are loans with a one percent interest rate, with all debt service deferred for the remaining term of the longest currently existing Agency loan. The advantage of this type of funding is that it does not require a rent increase. The disadvantages are that this type of funding is expensive to the Agency and also quite limited. See the discussion in B.8. [below] for situations in which this MPR tool may be appropriate.

5) **Zero Percent Loans.** Zero percent loans are loans with a 0 percent interest rate with a 30-year term that is amortized over 50 years. This funding may be used when the debt service of a Supplemental Section 515 loan will require an increase in basic rents at or above CRCU.

8. Other Considerations

Use of the Soft Second Loans. Less frequently, transactions with up-front cash needs (that cannot be covered from available third-party funding) will use the soft second loan tool to meet some or all of the project's needs. This MPR tool is appropriate for use when there is an especially strong reason to minimize the post-MPR basic rents. Because it is important to minimize basic rents in every transaction, and because this funding is both expensive and limited, the Agency restricts its use to those transactions with the most pressing needs. Underwriters should not propose this MPR tool unless (a) the project has a significant number of un-assisted tenants that are currently rent overburdened and (b) there is a compelling reason to minimize basic rents.