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HUD Training Based on Discipline

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AGENDA

- I. Introduction / Overview
- II. Risk Assessment / 5 Cs of Underwriting
- III. Building Blocks / Developers' Due Diligence Review
- IV. Concept Prep / Lenders' Due Diligence Review
Primary Market Area, Net Operating Income, and Environmental Report
- V. Pre-Application Submission
- VI. Firm Application Risk Mitigation
Case Study Objectives
- VII. Engaging Third Parties
Appraisal, Environmental, AEC / Green
- VIII. Mortgage Credit Review
- IX. Loan Committee Overview / Recommendations
Group Exercise
- X. Firm Application Submission
- XI. Firm Commitment / Extensions and Reopening Requests

Mortgage Credit

Mortgage Credit

1. Acceptable ownership structures
2. Identify principals
 - Underwriting
 - Signing Section 50
 - Controlling participants for Previous Participation/2530
3. Evaluating mortgage credit
 - Character
 - Creditworthiness
4. Determine financial strength



Borrower Structures Acceptable to HUD

- The Borrower must be a single asset entity.
- Acceptable Structures:
 - ✓ General Partnership
 - ✓ Limited Partnership
 - ✓ Limited Liability Company
 - ✓ Corporations
 - ✓ Non-Profit Corporations
 - ✓ Trust
 - ✓ Acceptable but not common (Condominiums, Cooperatives, Joint Venture)
- Non-Acceptable Structures:
 - ✓ Real Estate Investment Trusts (REITS)
 - ✓ Tenants in Common (TIC)
 - ✓ Delaware Statutory Trusts
 - ✓ Individuals



Identifying Principals

- HUD Definition of a Principal: Individuals and entities who exercise operational and/or financial control over a project.
- Two types of Principals: Active and Passive Principals.
- Active Principals:
 - Individuals or entities who possess financial and/or legal control of the Borrower, thereby requiring financial and credit analysis and underwriting;
 - Individuals or entities who will execute Section 50 of the HUD Regulatory Agreement and are subject to financial and credit analysis and underwriting; and
 - Individuals or entities who must disclose for Previous Participation Certification / 2530 review. $\geq 25\%$ ownership.
- Passive Principals:
 - Has limited or no decision-making power or control.
- **Identifying the individuals of the borrower as either active or passive is one of the most important decisions the MAP underwriter must make! Read Map Guide Section 8.3!!**

Identifying Principals

- Not all principals are treated the same!
- Ownership percentage is **NOT** the determining factor of whether a principal is classified as active or passive.
- Certain entity types within the single asset Borrower are usually always considered Active Principals:
 - General partner of a limited partnership which is the single asset Borrower.
 - A managing member, even if they do have an actual ownership interest, in the LLC that is the single borrower.
- An individual may own less than 25% (partnership, LLC) or 10% (corporation) but still have operational and financial control.
- Read the Org Documents. Discuss with the Borrower. Identify problem areas early.

Previous Participation

Certifies that principals of the borrowing entity have acted responsibly and have honored their legal, financial and contractual obligations in previous participations.

- Guidelines issued October 2016 Notice 2016-15
- Incorporated into 2020 MAP Guide Section 8.3.3
- Lender must identify controlling participants; HUD makes final determination. May or may not be the same as for mortgage credit.



Previous Participation - Controlling Roles



Individuals or entities that own at least 25% of an entity that is a Specified Capacity:

- Manager or managing members of LLC
- General partners of limited partnership
- Partners in a general partnership
- Executive director or equivalent role of non-profit
- Members of for-profit corporations Board of Directors who are also officers of corporation and executive management team (President, CEO, etc.)
- Controlling stockholder of corporation (in most cases ownership interests will be at least 25%)
- Trustees of a Trust
- Individual or entity who will sign Section 50 of the Regulatory Agreement
- Any other person or entity determined by HUD to exercise day-to-day control, financial or operational over a specified capacity

Mortgage Credit Review – Levels of Review

- Full Mortgage Credit including REO Schedule (Section 50 signers)
- Full Mortgage Credit excluding REO Schedule (active principals not signing Section 50)
- Limited Mortgage Credit (management agents and general contractors, potentially others / passive participants)
- **Additional Roles that MAY require some level of Mortgage Credit Review**
 - **Management Company** – can be a principal, depends if there is an Identity of Interest; only need a full financial credit review if they are a sponsor or owner
 - **Housing Consultant** – in a non-profit development situation, is hired to do the work of a developer because the non-profit may not have the development expertise
 - **General Contractor** – is a principal per HUD guidelines
 - **Other Consultants** and other persons or organizations hired to furnish advisory services in project financing, construction or operation. (not common)

Mortgage Credit Review – Full MC Review

• Documents for Review:

- ✓ Organizational documents to determine roles, decision making authority and ownership percentage
- ✓ Resume demonstrating experience in rental real estate and development
- ✓ Executed Credit Release/Credit Report
- ✓ VOD/Bank Statement valid for 60 days
- ✓ REO Schedule with supporting documentation for loans that are of concern
- ✓ Financial Statements
- ✓ OFAC Terrorism Check; LDP, and SAM searches
- ✓ HUD 92013 SUPP with four boxes checked; sometimes trade references can be substituted with credit reports (MAP Guide 8.4.4B)
- ✓ Previous Participation/2530 following current guidelines
- ✓ Organizational Chart
- ✓ Internet Search
- ✓ Other Business Concerns

Mortgage Credit Review – Limited MC Review

- Some principals may have financial capacity but not full decision-making authority
- Limited review includes:
 - ✓ Resume
 - ✓ Credit release and credit reports,
 - ✓ Financial statements
 - ✓ VOD and bank statements for financial partner
 - ✓ Previous Participation(2530)
 - ✓ Organizational charts
 - ✓ HUD 92013 SUPP

Mortgage Credit Review – No MC Review for Passive Principals

Passive principals have no decision-making authority or financial capacity

BUT, if a passive principal is providing the initial project with cash investment (with no ongoing obligation to support the project), the availability of the cash must be verified.

Bottom Line: Every case will be different. The MAP underwriter must complete research on the borrower to determine who qualifies as principal and the level of mortgage credit required.

Mortgage Credit Review – Passive Principals (cont.)

- Attorneys, architects with only arm's length fee arrangement for services
- Minor corporate officers
- Subcontractors
- Brokers whose services are limited to referring the loan to a Lender and presenting information on behalf of Borrower
- Public housing agencies/authorities
- Officers of passive investors
- Tax credit investor partners who are Limited Liability Corporate Investors (LLCI) who are exempt from the 2530

Mortgage Credit Review

- A principal's business experience helps evaluate whether the property can be successfully operated.
- Principal's financials are analyzed to determine liquidity:
 - Cash to close
 - Cash to reach stabilization
 - REO shortfalls
 - Cash to fund excess repairs or operating shortfalls over the life of the loan

Mortgage Credit Potential Risks/Mitigants

- **Risks**

- Bankruptcy filings
- Delinquent Federal debt
- Legal actions or judgements
- Defaults
- History of late payments or negative or troubling trends

- **Mitigants**

- Strong business acumen and decision making
- Date of deficiency
- Track record since date of deficiency
- The back story to the deficiency



Credit Reports

- Mandatory for borrowing entity and all active principals
 - 2 types: personal and business
 - Must be dated within 60 days of when application is submitted to HUD
 - Merged reports for all 3 major bureaus are required for individuals
 - Compiled infill reports are not accepted
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- **Common Issues:**
 - Late Payments
 - Defaults
 - Public Records
 - Judgements/Suits



Verification of Deposit

- HUD requires FannieMae Form 1006 Request for Verification of Deposit or bank statements to balance bank accounts submitted for review.



92013 SUPP

- If the Borrower certified that a statement is true, and it is not...
- **Criminal Warning Statement**
- “I certify that the foregoing... is true and correct to the best of my knowledge and belief.”
- “**Warning:** HUD will prosecute false claims and statements. Conviction may result in criminal and/or civil penalties” (18 U.S.C. 1001 etc.)



Required Searches

- **SAM** – System for Award Management – Federal government will not do business with any parties or individuals listed
- <https://www.sam.gov>
- **OFAC** - Office of Foreign Asset Control – checks against possible threat to the United States; terrorism checks required by US Patriot Act
- <http://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx>
- **LDP** – Limited Denial of Participation – shows entities restricted from using certain HUD programs in specific geographic areas and for limited time periods.
- https://www.hud.gov/topics/limited_denials_of_participation

Financial Statements

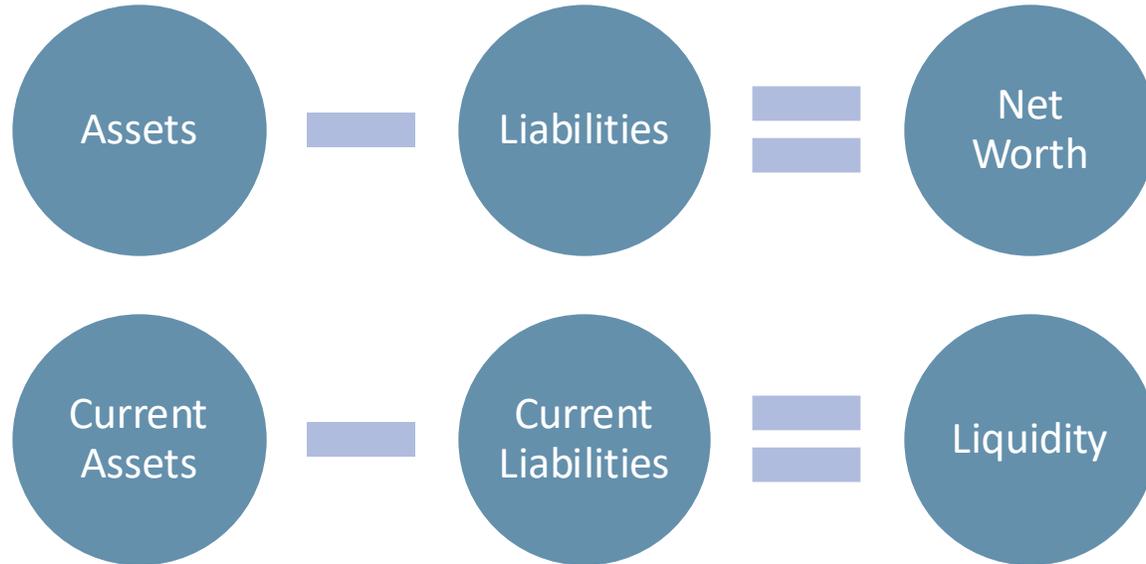
- Personal Financial Statements
- Business Financial Statements
- Most recent insurance and property tax bills, if available

- Questions:
 - Past financial condition
 - Present liquidity
 - Projected future financial capacity



Liquidity Ratios and Individual Performance Measures

- Net Worth
- Working Capital
- Key Formulas for Net Worth and Liquidity



- ... how much cash does the owner really have to use?



Analyzing the Personal Financial Statement

- REO
- Audit Reports
- 92013 Supplements
- Verifications of Deposit
- Debt Amortization
- Schedule of Outstanding Obligations
- Schedule of Loan Payoff Statement
- Tax Returns



Analyzing the Personal Financial Statement

- Verify the report is in proper form
- Information can be on HUD FORM 92417 or the equivalent information must be provided.
- **Notes:**
 - Confirm that all assets are owned, and liabilities are owned by the individual named on the statements
 - If spouse is not part of the mortgage; financials should not reflect spouse



Analyzing the Personal Financial Statement

- Investment property on a personal financial statement may be reported differently than on a corporate statement
- Personal statements are not reported using GAAP; values are reported at market and should be verified

Analyzing the Business Financial Statement

- 3 years of financials – audited and a certified year to date, if available.
- Balance Sheet
- Income statement or Statement of Operations
- Statement of Cash Flows
- Statement of Stockholder Equity
- Notes to Financial Statement



Developing an Overall Conclusion

- Financial statements reflect liquidity, net worth and financial details that can impact a borrower's capacity to undertake new debt.
- The underwriter determines the following:
 - Net Worth/Liquidity
 - Contingent Liabilities
 - Risks



REO Schedule Basics

- Is the Debt Recourse?
- Profit and loss % based on personal equity percentage
- Net cash flow to the principal
- Analyze the overall portfolio average DSCR
- Identify risks, and address in the Underwriter's Narrative
- The principal's concentration of real estate risk (the real estate may be overly concentrated in certain geographic areas or markets, or property types).
- The REO and balance sheet or PFS should reasonably tie together.
- The schedule calculates the principal's net annual cash flow (measure of future liquidity).



Completing the REO Section of the Underwriter Narrative

- Summary of REO portfolio & lender analysis
- Summarize underperforming assets:
 - DSCR less than 1.0; LTV greater than 80%
 - Is a refinance possible?
- Determine if owner values are reasonably valid
- Summarize maturing loans with in the next 5 years:
 - Is a refinance or sale possible? What are the owner's plans
- Compare REO schedule to principal's financial statement



Identifying Borrower Credit Risk

- Experience
 - Lack of Experience – bring in other principals (management company, general contractor, architect, etc.) with experience
- Creditworthiness
 - Creditworthiness may be caused by poor payment history, low FICO or credit scores, and poor outlook for business



Identifying Borrower Credit Risk: Legal Action /Liens/Judgments

- Contractors tend to have more frequent legal actions including liens. Management Agents frequently involved in lawsuits.
- Underwriter needs to determine whether the borrower is getting more than their expected share of actions.
- Other reasons for credit worthiness rejection include:
 - Judgments or actions which could significantly impact upon financial position of the individual firm or corporation.
 - Borrower is insolvent or subject of a pending bankruptcy or insolvency proceeding at the time of the application, Firm Commitment or at time of loan closing.



Experience in General

- **Mortgagor/Principal**
- **Management Agent**
- **Architect/Engineer**
- **General Contractor**
- **Attorney/Title Agent/Surveyor**



CONCLUSION

- Develop an overall conclusion as the Underwriter
- Identify credit risk(s) and provide mitigation
- Make a recommendation along with a thorough write-up to ensure the mortgage credit review is clear and concise



QUESTIONS?