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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
- 
- **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.)



# Identifying Borrower Credit Risk – 92013 Supp.

- Additional supporting documentation may include:
- Written explanation for any "yes" answers on the 93013 Supp.
- A letter from the affected agency, on agency letterhead and signed by an officer stating the delinquent federal debt is current or satisfactory arrangements for repayment have been made.
- Copies of court dockets or other third-party evidence of the status or closure of legal proceedings.



# 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](https://www.hud.gov/topics/limited_denials_of_participation)

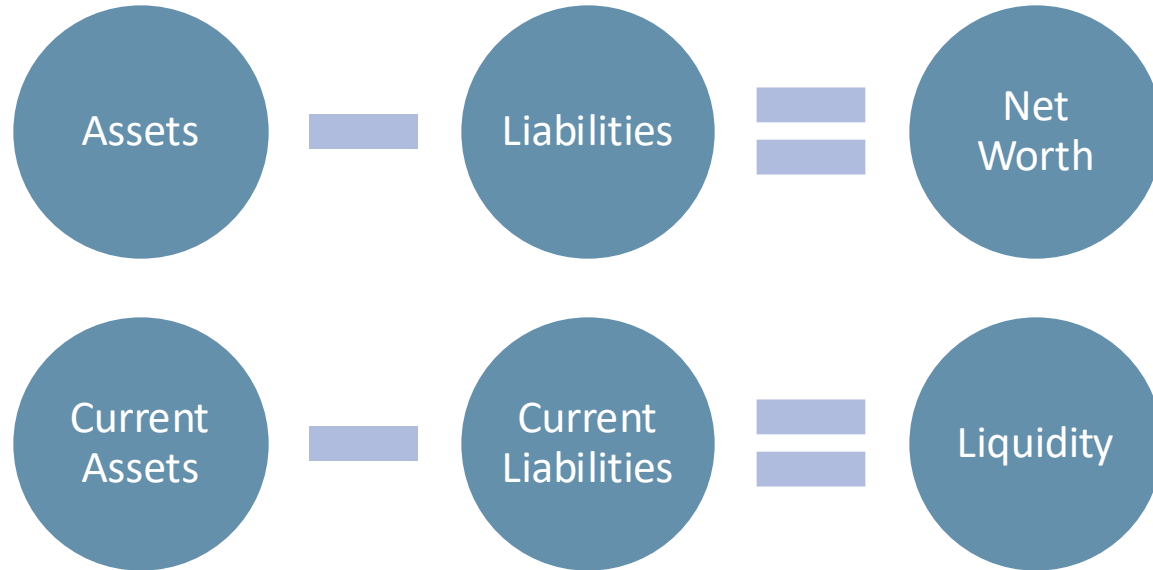
# Financial Statements

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