Self-Help 502 Loan Guidebook

PROVIDED BY REGIONAL T&MA CONTRACTORS

SECTION 523 MUTUAL SELF-HELP PROGRAM

Disclaimer

A handbook for grantees of the USDA Section 523 Self-Help Housing Program

Developed jointly by the Self-Help Housing Technical and Management Assistance (T&MA) Contractors:

- *Florida Non-Profit Housing, Inc. (FNPH)*
- *Little Dixie Community Action Agency, Inc. (LDCAA)*
- *National Council of Agricultural Life and Labor Research Fund, Inc. (NCALL)*
- *Rural Community Assistance Corporation (RCAC)*

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Refer to the Introduction chapter of this handbook to identify the appropriate T&MA Contractor to contact for your area. After receipt of consent and conditions letter you may copy and distribute the manual in accordance with such terms and conditions as set and approved by the T&MA Contractors.

CHAPTER 1

INTRODUCTION

The Self-Help Program

Self-help housing is just as it sounds, participants working together to build their own homes. This cooperative effort is a direct application of the church and barn raising traditions of pioneering rural Americans. Self-help participants, working in groups, supply the necessary labor to build their homes, having qualified for mortgage financing to purchase land, building materials, and some subcontracted work on the more technical items. A private nonprofit corporation, public body, a federally recognized Tribe, or rural town can obtain a grant from U.S. Department of Agriculture (USDA) Rural Development to hire skilled staff, rent office facilities, pay for mileage, and purchase tools. This staff then works with the participants by providing the assistance and training necessary to fulfill the goals of the self-help housing program. The program is described in more detail below.

With the assistance of the skilled staff, a group of generally four to ten households is formed. Once the grant is completed, at least 40 percent of the total participants served should be in the very low-income category and the remaining 60 percent of the participants would likely fall into the low-income category (see income map for details: https://www.rd.usda.gov/sites/default/files/RD-DirectLimitMap.pdf)

The participants select lots, house plans, (or in the case of purchase/repair programs, locate a suitable home) and apply for individual mortgage loans. While participants await loan approval, the group studies the responsibilities of homeownership, construction techniques, tool usage, safety, homeowner's insurance, taxes, home maintenance, and money management. This time is known as the pre-construction stage.

Once the loans are approved and closed, the group begins to build under the guidance of a skilled construction supervisor. The participants must complete a minimum of 65 percent of the construction labor tasks until the group of homes is completed; usually the more technical work such as electrical, plumbing and HVAC is subcontracted out. The construction stage lasts from six to twelve months, depending on the size of the group and other factors. Participants work during their spare time (evenings, weekends, and days off) so as not to interfere with the regular household employment. Rural Development loans feature fixed interest rates ranging from 1 percent to the current market rate, depending on the household's adjusted annual income. The repayment period is 33 or 38 years and no down payment is required.

Rural Development

Rural Development is an agency of USDA. The Rural Development mission is to help rural Americans improve the quality of their lives. Rural Development helps rural communities meet their basic needs by:

- Building water and wastewater systems.
- Financing decent, safe, sanitary and affordable housing.
- Supporting electric power and rural businesses, including cooperatives.
- Supporting economic and community development with information, technical assistance and funding.

Rural Development has been providing the funds for the self-help housing program since the late 1960s. They provide Section 523 self-help grants to eligible entities to start and implement the program and they thoroughly review the self-help application before a grant is awarded. When a grant is awarded, Rural Development is agreeing that there is a need for self-help housing in the area; the approved applicant is suited to administer a self-help housing program; the proposed plan, budget and schedule are feasible; the house plans meet local, state and Rural Development building codes; adequate building sites are available; the necessary project elements are in place; and Rural Development is ready to provide the requested financial resources necessary to make the project work. Technical assistance grant funds provided to self-help grantees by Rural Development do not have to be repaid. It is an investment Rural Development is willing to make in order to see self-help housing work.

Rural Development will continue to monitor and provide oversight in the areas of construction and administration, through quarterly meetings, construction inspections, and participant accounts throughout the term of the grant.

In most cases Rural Development provides another important ingredient to the self-help program; construction/permanent financing in the form of a Single Family Housing Direct Home Loan (Section 502). They are independent of private or conventional lending institutions; the financing is directly between Rural Development and the borrower. While labor and construction are group efforts, each applicant must qualify and obtain a loan individually from Rural Development. Rural Development's function as a lender is significant because private credit institutions in rural areas are relatively few in number, smaller, and often impose more rigid terms which can be a barrier to homeownership.

Rural Development Offices

Rural Development usually operates from four levels: national, state, area and local. The National Rural Housing Service Administrator in the National Office and the State Directors are politically appointed—all others are federal civil service employees.

Rural Development National Office

The Rural Development National Office is responsible for developing policy and interacts with Congress for legislation, development and program funding. The National Office also obligates and monitors all Section 523 self-help grants. The program staff at the national level maintain reports and statistics on operating self-help organizations and projected needs for funding. The National Office has a separate Appeals Division that hears appeals on actions unresolved at the state level.

Rural Development State Office

The State Office has the approval authority over smaller Section 523 Self-Help grant applications up to $300,000. Section 502 home loan funds are allocated on a state-by-state basis and the State Office allocates the 502 money based on a state Rural Development formula. There are additional staff members who are key to the operation of a self-help program located in many State Offices:

- Rural Development State Director
- Rural Housing Program Director
- Rural Development Architect
- Rural Development Appraiser
- Rural Development Housing Specialist

Rural Development Area Office

The Rural Development Area Director is typically responsible for the Section 523 grant. In some states however, the grant monitoring has been retained at the State Office level with the Single Family Housing Program Director or it has been assigned to the Local Office. In any case, the Rural Development grant manager is responsible to ensure that the grant is operated effectively and in accordance to regulations. Rural Development will evaluate the Section 523 self-help agencies on a quarterly basis and review grant applications for new and on-going programs.

Rural Development Local Office

Within this office, the Area Specialist is typically responsible for making the Section 502 home loans to participating applicants of each self-help group. He or she will be responsible for monitoring the 502 loans, custodial accounts and will also be the co-signer on the participant's Supervised Bank Accounts and will process the draws.

They are the personnel who will convert the loans once the local jurisdiction has completed the final inspection and issued a Certificate of Occupancy.

The Rural Development Section 502 Single Family Direct Home Loan

Many applicants that participate in the self-help housing program use Rural Development's Section 502 home loan program to finance their homes. Section 502 loans are only available for homes in eligible rural areas as defined by USDA (www.rd.usda.gov).

In order to qualify for a Section 502 direct loan, prospective self-help applicants must meet Rural Development income eligibility requirements as low-income or very low-income. (see the income map for details: https://www.rd.usda.gov/sites/default/files/RD-DirectLimitMap.pdf) They must be credit-worthy, have repayment ability for the loan requested, and be unable to secure credit from other sources.. These income standards, established by the U.S. Department of Housing and Urban Development and adopted by Rural Development, are subject to local variation and periodic change. Current information on income standards and eligibility requirements for Section 502 loans is available at Rural Development local offices or online at www.rd.usda.gov.

The repayment period for the Section 502 loan is either 33 or 38 years, and the interest rate is between 1 percent and the current market rate. The actual rate of interest the borrower pays depends on the borrower's income, as does the loan term. If a borrower is eligible to pay less interest than the market rate, the borrower then receives a subsidy called “payment assistance.” The amount of payment assistance a borrower receives is determined by the loan amount, loan period, and the household income. The assistance makes up the difference between the full loan interest rate and the interest rate the participant pays. A portion of this subsidy must be repaid at time of sale or loan payoff based on equity, time, etc.

During home construction, Section 502 funds are advanced from the Rural Development finance office in St. Louis and disbursed by the local offices to the self-help grantee. Grantees prepare the drawdowns and checks for each participant’s account as needed to purchase materials for different phases of construction. Note that the participant’s loan payments are deferred during construction.

When construction is complete and all the necessary funds have been withdrawn from a participant’s account, Rural Development's finance office sends payment books/payment coupons to the participant. The participant’s first loan payment is due within 30 days of conversion (termination of deferred payments). Payments then go directly to Rural Development’s National Financial and Accounting Operations Center (NFAOC) in St. Louis.

The 523 Mutual Self-Help Housing Technical Assistance Grant

In order to enable organizations to operate a mutual self-help housing program, Rural Development provides grant funds to operate and oversee the program. Each technical assistance (TA) grant is usually for a period of up to two years, and is available to public and private nonprofit organizations, federally-recognized Tribes and units of state or local government. The amount of grant funds an organization can receive is based primarily upon how many houses they build in a grant period. An organization can generally receive up to 15 percent (based on a formula) of the average cost of a new home financed under the 502 program in its area, for every home they are planning to build.

Activities that are allowable uses of Section 523 technical assistance grant funds include:

- Recruit eligible households to participate in the self-help program.

- Hold training meetings with participants on the self-help process and homeownership topics such as mortgages, insurances, taxes, and maintenance.
- Assist participants to obtain and develop building sites; obtaining or creating Rural Development-approved house plans and helping participants select theirs.
- Help participants bid and select building supplies and subcontractors; train participants in construction techniques and provide construction supervision.
- Supervise participant Section 502 loan accounting, including:
    - Totaling invoices and itemizing payments to suppliers and subcontractors.
    - Maintaining records of deposits and withdrawals.
    - Preparing checks (accompanied with invoices and statements).

Disallowed activities using Section 523 Technical Assistance grant funds are:

- The use of any TA funds to pay staff to provide labor on the houses
- Purchasing any real estate or building materials for participating families
- Paying any debts, expenses or costs that should be the responsibility of the participating families
- Any lobbying activities as prohibited in OMB Circular 2 CFR 200 subpart f.

The T&MA Contractors

In 1979, appropriations language was changed to authorize the use of Section 523 grant funds to contract for technical assistance to self-help grantees. Currently there are four Technical and Management Assistance (T&MA) Contractors.

Rural Development contracts with these groups to assist operating and potential self-help housing grantees across the country. This assistance comes in the form of staff and board training, grant management, development of applications, 502 loan program and processing training, newsletters and conferences, among other services. These services are provided at no cost to the grantee.

The four contractors are:

- Florida Non-Profit Housing - covering Region I, the Southeast, including the states of AL, FL, GA, MS, NC, SC, TN, Puerto Rico and the Virgin Islands.

- Little Dixie Community Action Agency, Inc. – covering Region II, the South Central US, including the states of AR, KS, LA, MO, ND, NE, NM, OK, SD, TX, WY.
- NCALL Research, Inc. – covering Region III, the Northeast and Midwest, including the states of CT, DE, IA, IL, IN, KY, MA, MD, ME, MI, MN, NH, NJ, NY, OH, PA, RI, VA, VT, WI, WV.
- Rural Community Assistance Corporation (RCAC) – covering Region IV, the Western US, including the states of AK, AZ, CA, CO, HI, ID, MT, NV, OR, UT, WA, and the Western Pacific.

Self-Help Training Guides and Handbooks

The T&MA Contractors have produced a variety of training materials for the purpose of assisting grantees and training grantee staff. The following is a list of the available self-help guides and handbooks. Please contact your T&MA Contractor for a copy or for more information.

Boards of Directors Training Guide

Boards of Directors play a critical role in the success of any non-profit organization. With this in mind, the Board of Directors Training Guide was designed for use by board members of any housing agency. It is an informational resource that may be used as a training tool and can provide new insights and a clearer understanding of nonprofit organizations, board meetings and operations, agency planning, administration of agency personnel, teamwork, orientation for new board members, federal accounting requirements, and agency activities.

Program Director Handbook

It is the responsibility of the Program Director or Executive Director to administer a successful self-help housing program. This handbook takes a general look at the process of managing a self-help program as well as providing specific information on required reports, program criteria, grant and financial management, personnel, and fair housing.

Construction Supervisor Handbook

The Construction Supervisor Handbook discusses the roles and responsibilities of the construction supervisor as it relates to self-help housing. This handbook covers aspects of the construction supervisor's job; from construction specifications, house plans, schedules, bill paying procedures, to group motivation. Insight is provided on how the self-help program operates and what is expected from the construction supervisor.

Group Coordinator Training Handbook

Group Coordinators are central to the self-help program throughout the self-help participant's involvement from recruitment through construction and move-in to the completed homes. This handbook provides guidance for the group worker in maintaining effective communication and relationships within the group of self-help participants throughout the self-help process.

Financial Management Handbook for Federally Funded Organizations

The purpose of the financial management handbook is to aid new and operating self-help grantees with the development of financial management systems and policies that are compatible with the fiscal responsibilities set forth by the funding agency (Rural Development) and the Office of Management and Budget (OMB). While self-help housing programs that have been operating for many years may have sophisticated financial systems and policies, others are lacking written, established financial procedures that assure proper internal controls.

Individual Borrower 502 Loan Accounts

The self-help housing grantee is responsible for keeping an accurate account of the disbursements of funds from the individual self-help family's Section 502 loan accounts. Rural Development Instruction 1944-I indicates that the technical assistance provided by the grantee to the families should include "providing financial supervision to individual families with Section 502 loans, which will minimize the time and effort required by Rural Development in processing borrower expenditures for materials and contract services." This handbook provides guidelines for self-help grantees to use in designing the procedures necessary for a reasonable standard of control and a system of checks and balances to protect the participants and the grantee.

Self-Help 502 Loan Guidebook

While the labor and construction are a group effort, each participant must qualify and obtain a loan individually from Rural Development. In order to qualify, a household must fall within the income guidelines set by Rural Development, must have demonstrated repayment ability, must have a good credit rating, and should have a low debt load. Because the 502 self-help loan process can be complicated for the individual, the technical assistance staff will prescreen participants for program eligibility and prepare the application packages for Rural Development. The Self-Help 502 Loan Guidebook will help to train the Group Coordinator or appropriate staff person in packaging these loans.

Preconstruction Meeting Guide

Each self-help grantee is responsible for organizing participants into self-help groups, which remain together from loan processing through construction. The organization of participants into groups reinforces the "mutual" aspect of the self-help program because participants within a group are expected to work on each other's house until all houses in the group are completed. In addition to organizing participants into groups, self-help grantees are responsible for explaining the self-help concept and methodology to participants, and for educating participants about their responsibilities as self-help participants, 502 loan borrowers, and homeowners. This is achieved through a series of "pre-construction meetings" which are covered in this handbook.

CHAPTER 2

OVERVIEW

Rural Development (RD) provides a critical ingredient to the self-help program by offering financing through Section 502 Direct Loans to eligible low-income, rural residents for the land and all related costs during construction, which then converts to a long-term affordable mortgage upon completion. This chapter is an overview, with details on key aspects in following chapters.

Advantages of the Section 502 Loan

- ✓ Reasonable rates and terms
- ✓ Typically, no down payment requirements
- ✓ Some closing costs may be included in the loan, up to the appraised value
- ✓ Private Mortgage Insurance (PMI) is not required (this can be hundreds of dollars per month)
- ✓ Up to 100% financing on new construction homes or to purchase an existing home
- ✓ Payments are based on household income
- ✓ Direct loan from RD
- ✓ Additional loan servicing components such as workouts and moratoriums as needed

Section 502 Direct Loans are loans that are directly funded by the government and not funded by a lender and then guaranteed by the government. These loans are available for low and very low income households located in rural areas to achieve homeownership.

The purpose of this loan is to provide financing at reasonable rates and terms typically with no down payment. Funds are loaned directly to the borrower from Rural Development and initially functions as a construction loan and then permanent financing. Mortgage payments are based on the household's adjusted income. The repayment period is typically 33 or 38 years, and the interest is similar to market rate and is then subsidized by lowering the interest rate to between 1 percent and the current market rate as a means to create affordability. The actual accrual of interest the borrower pays depends on the borrower's income, as does the loan term.

If a borrower is eligible to pay less interest than market rate, the borrower then receives a subsidy called "payment assistance." The amount of payment assistance a borrower receives is determined by the loan amount, loan period and the household income. The assistance makes up the difference between the full loan interest rate and the interest rate the participant pays. Borrowers are required to repay all, or a portion of the payment subsidy received over the life of the loan when the title of the property transfers or the borrower is no longer living in the dwelling. The amount an applicant may be required to repay is based on a formula including the amount of subsidy received, time elapsed, equity, etc.

While the labor and construction are a group effort, each participant must qualify and obtain a loan individually from Rural Development. In order to qualify, a participant must fall within the income guidelines set by Rural Development, must have demonstrated repayment ability, must have acceptable credit history and should have a low debt load. Because the application process can be complicated for the individual, the self-help grantee is responsible for pre-screening applicants for program eligibility and preparing the application packages for Rural Development.

In order to qualify for a Section 502 loan, prospective self-help applicants must meet Rural Development's eligibility requirements:

- ✓ Income eligibility requirements as low-income or very low-income
- ✓ Credit-worthiness; have repayment ability for the loan requested
- ✓ Be unable to secure credit from other sources on terms and conditions that they can reasonably be expected to meet
- ✓ Have the legal capacity to incur a loan obligation
- ✓ Meet citizenship or eligible noncitizen requirements
- ✓ Not be suspended or debarred from participation in federal programs

Applicants may obtain 100 percent financing to purchase a site and construct a dwelling as long as the area loan limit isn't exceeded. Some closing costs may be included in the loan, depending on the type and the effect on the loan to value ratio. The Section 502 loan can be combined with other affordable housing funding sources, i.e. Self-Help Opportunities Program (SHOP), Affordable Homeownership Program (AHP), HOME funds or other leveraged sources.

Mutual self-help new construction loans are closed prior to any work beginning on the homes, making the participants true owner builders. During construction, Section 502 loan funds are advanced from Rural Development's National Financial and Accounting Operations Center (NFAOC) in St. Louis and disbursed by the local Rural Development offices to the self-help grantee. The borrowers do not make payments on the loan during construction of the homes. Grantees prepare drawdowns and checks for each participants' account as needed to purchase materials or pay for subcontracted work as dictated by the grantee, for the different phases of construction. (See Chapter 9 of this guide *Construction to Permanent Loans* and the separate guide, *Guide to Individual Borrower 502 Loan Accounts.*) Upon construction completion the checking accounts are closed out, the loans are converted from construction to permanent mortgages and NFAOC services the loans for the term of the mortgage.

What regulates 502?

The program is regulated by 7 CFR 3550 and handbook HB 1-3550, Administrative Notices (AN), Procedure Notices (PN), Unnumbered Letters (UL), Forms, Instructions, etc. Changes in program guidance and implementation often are found on the Rural Development website and you can receive notification through their ListServ. Other applicable Rural Development instructions include:

1924-A "Planning and Performing Construction and other Development"

1924-C "Planning and Performing Site Development Work"

1901-E "Civil Rights Compliance Requirements"

1970 series "Environmental"

ListServ

Regulations change often, keep up by signing up for the ListServ.

The Single Family Housing Direct Loan Division has GovDelivery available for you to receive program updates. Using the link, enter your email and select the "SFH Direct Loan and Grant Programs" (and any other programs of interest) and then click "Submit"

https://public.govdelivery.com/accounts/USDARD/subscriber/new?qsp=USDARD_25

USDA prohibits discrimination on the bases of race, color, religion, sex, age, national origin, marital status, familial status, disability, limited English proficiency, or because all or a part of an individual's income is derived from a public assistance program. You need to be familiar with all of the Civil Rights and Fair Housing Laws and more information is available in the Self-Help Group Coordinator Handbook.

RD Handbook 1-3550

Handbook 1-3550 is the loan processing handbook designed for the Rural Development Loan Officer and other Rural Development staff and covers everything from receiving the application through loan closing and construction. This handbook will be of great value to you throughout the packaging process and is relatively easy to use. The most current version is always available on-line on Rural Development's website and is searchable for key words by right clicking and selecting "Find" or by selecting "ctrl F." It is not recommended that you print this guidebook, it's rather long and changes often. If you're accessing it on-line, you're always assured you are using the most current version.

Funding Availability and Allocations

Every year the President submits a budget that requires passage by both houses. This can be a protracted process, full of uncertainty, but usually a continuing resolution will keep some funds flowing. Although the budget should be approved prior to the October 1 start of the fiscal year, it may be approved in November or later, there are a lot of reasons for budget delays. Each house of the legislature comes up with their version of the budget, then both houses must agree on the final. Allocations are then made per program at the national level, then allocated internally by the national office by program and by state. Additionally, the national office typically maintains national reserves to fund loans.

Many times, the government is under a continuing resolution because the budget has not been approved. Because of this, loan funds are based on percentage of historical use of funds for the same time frame, for example, a two-week CR on October 1 would mirror the funds obligated in the prior year for the first two weeks in October.

There are special funding allocations under the 502 program. Usually, all of these funding allocations designate between low-income and very low-income. These categories can vary by year and often includes self-help housing, check with RD for this year's categories.

Applications are accepted year-round and processed to the extent possible whether funds are available or not. If you are in doubt about the availability of Section 502 funding, contact your local Rural Development office.

Priority Processing

Processing Section 502 applications is *not* always done on a first come first serve basis, there is a priority system that is used only to determine the order in which applications will be processed. Once applicants are selected for processing (e.g. a Certificate of Eligibility is issued), the order in which they actually receive funding will depend on how long it takes the applicant to respond to requests for information and be ready for closing. The priority also applies when funding is insufficient to fund all applications on hand.

RD gives processing priority to applicants who have an especially serious need for immediate assistance and for loans that are to the Agency's benefit. Applicants with higher priorities must be processed before those with lower priorities. Applicants who do not qualify for any priority should be processed only when no applications with a priority remain unprocessed. Within each priority category, applications are processed in the order they are considered complete. This includes packaged self-help applications in priority #4.

Area Loan Limit and Maximum Loan Amount

Area loan limits are published annually by Rural Development and are 80 percent of the FHA Forward One-Family mortgage limits (HUD 203(b)). In order for a property to be financed, it must be "modest," which is a property that is considered modest for the area, does not have a market value in excess of the applicable area loan limit, and does not have certain prohibited features (like income producing structures/businesses).

The total Rural Development loan cannot exceed the area loan limit and is made up by the combined indebtedness, all liens on the property, except for Agency authorized purposes. There are four expenses that can exceed the area loan limit, they are Rural Development tax service fee, initial escrow deposit, appraisal fee and the homebuyer education fee. For self-help new construction, this means the cost of the land, materials, grants, loans and the value of sweat equity cannot exceed the area loan limit. Sweat equity is calculated by subtracting the cost of the land, materials, grants and loans from the appraised value. The appraised value also cannot exceed the area loan limit.

Packaging Process

Packaging Section 502 loans involves many steps, the big picture includes intake, processing the application and information, and submitting a complete package to Rural Development for eligibility determination. Attachment 3-A provides processing guidance for loan application packagers.

Step 1: Prequalification/Intake

This involves gathering initial, unverified information from the applicant to conduct an initial eligibility evaluation and program interest. Not all interested applicants will be candidates for self-help once they learn about the labor contribution and/or time commitment, this is a good time to make them aware of these things, share the Group Agreement and the wonderful things about the program as well.

You'll want to use an in-house pre-application or intake form to gather information at this stage (an example is in the Group Worker Guide). If the applicant isn't a good fit during this initial intake, the grantee will usually let them know what they need to do, for example, repair credit and wait before moving on to step two. This information may change several times during this phase or when the information they've provided is verified, just be sure the applicant doesn't feel like promises are being made about payment amounts or program participation at this time or at any time prior to COE and actually finalized at closing.

Step 2: Verifying Information

Here the packager begins to collect third party verifications on income, debts and other specific household information. These documents are readily accessible to the applicant and generated by a third-party, such as paycheck stubs, bank statements, and benefit award letters the applicant has received or has available to them. Many grantees provide a checklist to the applicants including all of the third-party verifications they should gather before they meet during this phase (or even for the first time). Nationally, grantees process 15 to 20 applications before they find an eligible participant.

Step 3: Assembling the Application Package

Once you've gathered verifications, you will begin to put everything together that Rural Development needs to make an eligibility determination. You'll need to make sure all third-party documents (like paystubs) are as current as possible and that all of your documents match; does the 4-A calculator match the loan narrative and paystubs, etc. Do not include anything in the file that won't assist Rural Development to make an eligibility decision.

Step 4: Application Submission

Once you're ready to submit the application to Rural Development, it is important to check again that all of the submission documents are as current as possible and everything lines up; the paystubs match the 4-A calculator, the 4-A matches your loan narrative, etc. There is no time that applications must be submitted or are accepted. There is an order for documents when filling electronically in Attachment 3-J (Appendix 7), which may be helpful in organizing your documents no matter how you are submitting. However, some Rural Development staff do have preferences for how they like to receive applications, which may require a conversation with them.

4-A Calculator

The 4-A automated calculator is used to document income, assets, debts and requested loan amounts and other funding. The packager will often use and revise the calculator throughout the application process to determine preliminary program eligibility, calculate estimated loan payments and when combined with the loan narrative, will address all eligibility criteria.

The most current 4-A Calculator and a webinar tutorial on how to use the calculator are available on RD's website. You'll want to frequently check their site to ensure you are using the most current version.

When you're first working with the calculator, don't be afraid to play with it, you can't hurt it. Pretend you're qualifying yourself, a friend or family member and change the circumstances to see how things change.

Loan Narrative and 4-A Calculator

When combined, the loan narrative and the 4-A calculator is how you tell the story of the application and make a recommendation regarding the applicant's eligibility. It is recommended that these documents be the first thing in your submittal that Rural Development sees—everything after these pages will document and support your recommendation. This narrative should address all of the eligibility criteria but does not include any statements of personal opinion, just the facts. Just like every applicant's financial and household information is different, every loan narrative will be different.

4-A Calculator

The 4-A calculator is an automated calculator Rural Development has developed to document income, assets, debts and requested loan amount/funding. Comment sections contained in the calculator can be used to explain income. Both the packager and the Rural Development Loan Officer complete the 4-A, with Rural Development's being the final version. Rural Development will review your 4-A, and based on its underwriting, make any needed changes. Ideally, the calculations you arrive at and the calculations Rural Development arrives at, should be close or the same. It is helpful to get a copy of Rural Development's completed calculator for each application to determine if there are any differences and why. Ultimately, you want to get to a point where they match and in order to do this some coordination and questions are usually required. There are webinars and instructions for filling out the calculator on Rural Development's website and when updates are made to the calculator, the newest version is always available there. It is important to go there often to ensure you are using the most current form.

Loan Narrative

It is not necessary to restate items from the 4-A calculator in the loan narrative, the narrative supplements the calculator. In the loan narrative, focus on any exceptions, explanations or any requested waivers. Between the loan narrative and the 4-A calculator, you should include analysis of the following:

Purpose

Outline the loan being requested

Background

This section should include a brief background on the borrower's present situation including household composition/dependents. Do not include any statements of opinion i.e. "They are such a nice and wonderful couple, they'll be great in the program."

Terms of Loan

Outline the various costs that will comprise the total loan amount and how long of a term is recommended; 33 or 38 years i.e., the household is below 60 percent AMI and can only afford the needed loan amount for a 523 home with a 38-term loan.

Employment/Income

Reference the 4-A and provide any context on their employment situation and source of income, how many people work in the household, term of employment, were there any gaps more than 30 days in the last two years (if so you'll need a statement from the applicant), is there overtime or bonuses, which borrower income category - Low or Very Low. This should also be included in the comments section of the 4-A calculator.

Income Calculations

Reference the 4-A calculator and make sure you address which method you chose and why (i.e. I showed Mary receives an average of 30 hours per year in overtime) on both the loan narrative and 4-A comments; which calculation method did you choose AND WHY.

Deductions

Are they paying child care to a source that counts (e.g. not a household member) and how much, does this match their tax documents, etc.? How many children do they have, how old, etc.

Assets

Outline source and amount of assets. Double check that their application is accurate, e.g. they pay car insurance so they must own a car. Always mention you reviewed for assets even if they don't have any.

Credit History

Outline the borrowers credit history including their credit score or if nontraditional credit was used to evaluate credit history. If you used nontraditional credit, indicate that you started with the preferred sources and included those in order of preference that were available. Identify how many sources you needed to get and what you included. If there are student loans, are they on an income-based payment, how much did you use for monthly payment and why/what's the justification (and this needs to be backed up with documentation from the lender).

Other Funding Sources

Will there be any other sources of funding needed or contributed and if so, what are the terms (i.e. will there be payments with interest, will it be forgiven at some point, etc.).

Debt Ratios

Provide a breakdown and composition of Total Debt and PITI and outline monthly debt amounts.

Payment Shock

Show calculation and/or provide the percentage

Homebuyer Education

HBE is required at the time of submission for eligibility, if you are not including it in your initial application submission, you need to state as such and when it will be completed.

Summary and Conclusions

Outline why the Borrower qualifies or does not qualify for a Rural Development loan.

Packagers Recommendations

Do you recommend them for a loan?

Sign and Date

Use the date you actually submit the package.

CHAPTER 3

CALCULATING INCOME AND ASSETS

This chapter correlates with Rural Development Handbook 1-3550 Chapter 4.

Steps for the Packager

1. Create checklist for applicants of documents required for application submission (example in Appendix 1), i.e. paystubs, tax returns, bank statements, asset documents, other income and deductions.
2. Gather required income documentation to make the best projection of their income, assets and deductions for the next 12 months.
3. Calculate 4 methods of income on the 4-A income calculator spreadsheet.
4. Recommend method to determine household annual income on 4-A.
5. Calculate assets for their impact on annual and repayment income and down payment requirements on the 4-A.
6. Calculate repayment income for note signers on the 4-A.
7. Calculate adjusted income based on annual income on the 4-A, by completing the 5 deduction section.
8. Review results of the 4-A with applicant showing possible loan amount, debt to income ratios including problems and possible solutions.

Three Types of Income (Annual, Repayment, Adjusted)

Three Types of Income

1. ANNUAL
2. REPAYMENT
3. ADJUSTED

To be eligible for a loan, the applicant must demonstrate that they have a stable, dependable source of income. Income information is used to determine whether the applicant's household is eligible for the loan and the amount of payment subsidy the household can obtain. The applicant's income is used to determine the amount of the loan they can afford to repay based on the programs criteria. There are three income types and it is important to use the correct type and income from the appropriate household members for the correct purpose.

Annual Income

Annual income is the first step to determine the applicant's eligibility for assistance. Annual income is defined by RD as "All amounts, monetary or not that are not specifically excluded by regulations, that go to, or are received on behalf of, the applicant/borrower, co-applicant/co-borrower, or any other household member (even if the household member is temporarily absent)." In other words, the gross income from all adult (18 years and older) household members is considered. For full-time students, 18 and older, who are considered dependents and not applicants (see dependent definition below), only the first $480 of earned income is counted. This $480 of full-time student income will later be cancelled out by a $480 dependent deduction for full-time students under the adjusted income.

INCOME NEVER CONSIDERED IN ANNUAL INCOME

1. Payments received for the care of foster children, or foster adults (usually individuals with disabilities who are unable to live alone).

2. Deferred periodic payments of supplemental security income and Social Security benefits that are received in a lump sum amount or in prospective monthly amounts.

3. Adoption assistance payments in excess of $480 per adopted child.
* See HB-1-3550 Paragraph 4.3 D. for additional excluded income sources and information

Repayment Income

Repayment income is used to determine whether an applicant has the ability to make monthly loan payments. It is based only on the income of those who will be parties to the note and includes some income sources excluded for the purpose of annual and adjusted income. The parties to the note or note signers are those household members who will continuously live in the home, are responsible for the payments for the full 33- or 38-year term and who are legally capable of entering into a mortgage agreement. All sources for the note signers that are considered "stable and dependable" are counted and unlike adjusted income, none of the five deductions are applied. Repayment income is also used during servicing, but only to determine if a borrower is eligible for a Moratorium or Re- amortization as described in HB-1-3550 Appendix 1.

Adjusted Income

Adjusted Income is used to determine whether a household meets the income eligibility and the amount of payment assistance, they are eligible for. It is based on annual income and provides deductions for certain household circumstances and expenses. There are five different types of deductions and some applicants will have significant deductions and others none.

Annual Income

Whose Income Is Counted?

The income from all adult (18 years and older) household members is considered. For full-time students who are considered dependents (see dependent definition below), only the first $480 of earned income is counted (social security, child support and other forms of unearned income are entirely counted). The applicant determines the members of their household on the loan application. Those members who are temporarily absent are also counted if they consider the home their permanent residence. These individuals may be temporarily absent from the household for a variety of reasons, such as temporary employment or students who live away from home during the school year, but their income is included in the household income. An individual permanently confined to a nursing home or hospital may not be the applicant or co-applicant but may be counted as a family member at the family's discretion. Live-in aides, foster children, and foster adults living in the household are not considered household members and therefore their income is not included.

What Income is Counted?

1. You will need to count the gross amount, before any payroll deductions, of base wages and salaries, overtime pay, commissions, fees, tips, bonuses, housing allowances, and other compensation for personal services.
2. You also count the net income from the operation of a farm, business, or profession. (See Paragraph 4.3 #2 of HB-1-3550 for further details.)
3. Interest, dividends, and other net income of any kind from real or personal property. (See Asset section for further details.)
    - The full amount of periodic payments received from Social Security, before deductions, (including Social Security received by adults on behalf of minors or by

minors intended for their own support, or by an applicant who is a representative payee for an adult household member who will reside in the property) is counted.

4. Annuities, insurance policies, retirement funds, pensions, disability or death benefits, and other similar types of periodic receipts. However, deferred periodic amounts from supplemental income and Social Security benefits that are received in a lump sum amount or in prospective monthly amounts are not counted. You will need to review each of these to determine if they are received regularly or if they are one-time events. If they are one-time or irregular payments, they would be counted as part of their assets.
5. Payments in lieu of earnings, such as unemployment and disability compensation, worker's compensation, and severance pay. Unemployment income requires a two-year documentation of receipt and reasonable assurance of its continuance.
6. Public assistance (except as indicated in Paragraphs 4.3 C. and D – HB-1-3550)
7. Periodic allowances, such as:
    - Alimony and child support received by the household; or
    - Recurring monetary gifts or contributions from an organization or person who is not a member of the household.
8. All regular pay, special pay (except for persons exposed to hostile fire), and allowances of a member of the armed forces who is the applicant or spouse, whether or not that family member lives in the home.

Repayment Income

Repayment Income is used to determine whether the potential applicant has repayment ability and is often not the same as annual income. The key concept in repayment income is, whether it is stable and dependable; will the borrower have the income necessary to make their mortgage payment for the term of the loan. To determine this, it is necessary to consider the income of only the note signers, these are the individuals who will be responsible for the mortgage for the life of the loan. You want to ensure you're evaluating all stable income sources and project income for the next 12 months.

Repayment income will then be used to complete ratio calculations and repayment ability. Repayment income typically uses the same income documentation as annual income, which typically includes, but is not limited to, paystubs for their current income and tax returns showing previous income. (See Chapter 6 of this guide for additional verification information.)

Stable and Dependable

The applicant/co-applicant must have adequate and dependable income. Whether or not income is dependable will include consideration of the applicants' past employment history. Rural Development has no minimum history requirement for employment in a particular position. The key concept is whether the applicant has a history of receiving stable income and a reasonable expectation that the income will continue.

The packager reviews the applicant's income to establish whether it can reasonably be expected to continue for the next two years. An applicant may have worked for three employers in the past two years, but during that time they exhibited a stable income. For example, when reviewing the past two years of employment history for Sam, you see she worked for a long-haul trucking company for a year and then went to work for a local department store for six months because the hours were better, then she took a job through a temp agency as an office assistant to be closer to her kids' school for the last six months. Last year Sam earned $30,000; the year before she earned $28,000; and this year she's projected to earn $30,500. This applicant has demonstrated a stable income for the past two years even though it has involved multiple work/employers and even though her current job is temporary in nature. This is acceptable. The applicant does not have to show two years with the same employer, in the same position or receive the same wage, the analysis is looking at income stability, not employer stability. Gaps of employment in excess of 30 days however, must be explained in writing by the applicant, unless it is clearly seasonal in nature. Rural Development will review the employment gap explanation to make a determination on the applicant's ability to receive stable and dependable income. If the applicant's income source is determined to be unstable and undependable, the income must be excluded from repayment but included in annual income.

Another example would be seasonal worker (i.e. construction worker) who may work for four or five different employers in a year and is typically employed from February through October but doesn't work from November through January. The last two tax returns indicate $42,000 per year including their unemployment benefits. Let's say that this applicant applies for the loan in December when they are receiving unemployment benefits. They wouldn't necessarily be denied the loan for lack of repayment income just because they are receiving unemployment at the time. They have a history of that so you could determine that for the last two years they have shown a stable income of $42,000 so it’s likely to continue. The applicant wouldn’t be denied simply because the applicant is on unemployment due to the seasonal nature of their job.

If there is a <u>known</u> end date to a source of income (child support, contract work, benefits) within two years, this is not considered stable and dependable and will not be included in repayment income. For example, the applicant receives child support for a 16 ½ year old, which is scheduled to end when they turn 18, this would not pass the test for stable and dependable and would only be counted in annual income. But say that same child is 15, this income would be counted in both annual and repayment income because we consider all income likely to continue for the next two years, and this income covers more than the period of review.

Rural Development typically wants a two-year employment history for each applicant, however in some cases, a history of less than two years is acceptable. In these situations, you will need to complete a careful analysis to determine which income sources to include and their projections for the next 12 months. This may include an applicant who is either new to the work force, is on a probationary period, or has returned to the work force after an extended absence. Consider reasonable allowances for less than a two-year history under the following circumstances:

- The applicant has recently changed jobs but remains in the same line of work.
- The applicant frequently changes jobs but demonstrates income continuity.
- The applicant is a recent graduate, as evidenced by college transcripts, or a recent member of the military, as evidenced by discharge papers, entering the civilian workforce.
- The applicant has recently re-entered the workforce after an absence due to an extended medical illness, to care for a family member or minor child, or other similar circumstances.

Income Counted in Repayment Income Only

Repayment income includes all annual income received by the note signers/borrowers with the following differences listed below, which are counted as repayment income only. (Please refer to HB-1-3550 Paragraph 4.3 B. for a complete list.)

1. Housing assistance payment (HAP) through HUD's Housing Choice Voucher–Homeownership Program sometimes referred to as Section 8 for Homeownership.

2. Adoption assistance payments in excess of $480 per adopted child.

3. The full amount of student financial assistance received by note signers/borrowers or paid directly to the educational institution. Financial assistance includes grants, educational entitlements, work study programs, and financial aid packages. It does not include tuition, fees, student loans, books, equipment, materials and transportation. This also includes any amount provided for living expenses, these may also be counted as repayment income.

4. Amounts paid by a State Agency to a family with a developmentally disabled family member living at home to offset the cost of services and equipment needed to keep the developmentally disabled family member in the home.

5. The special pay to a family member serving in the Armed Forces who is exposed to hostile fire.

6. Income received from the Supplemental Nutrition Assistance Program (SNAP) is considered repayment income, if the applicant chooses, however in an amount not to exceed 20 percent of the total repayment income ("not to exceed" amount). The following provisions apply:

SNAP BENEFITS

Supplemental Nutrition Assistance (SNAP), formerly called Food Stamps, may contribute to Repayment income only, as long as it's received by those that are party to the note, not other household members. This is because RD has determined that an applicant who receives SNAP, money designated to spend on food, may have additional income to spend on their housing. The 4-A Income Calculator will automatically calculate the maximum amount using the not to exceed than 20% formula.

- Only the SNAP benefits attributable to the note signers can be considered for repayment income.
- Only the lesser of the “not to exceed” amount or the actual SNAP benefits can be included in the applicant’s repayment income.

Example: Marsha received $300 in monthly SNAP benefits and has a monthly repayment income of $1,000.

Step 1: $1,000/.80 = $1,250

Step 2: $1,250- $1,000 = $250 (20% of repayment income)

Step 3: The lessor of 20 percent ($250) or actual SNAP ($300) is counted for repayment. So, for Marsha, it would be $250

One challenge with SNAP, is that an applicant cannot apply for SNAP again until their current benefits expire and then it could be a couple of weeks to a month after that they receive the award letter. The SNAP benefits will be retroactive to the date their previous benefits expire, however you will have a short period of time without a current benefit statement. If you have an applicant whose SNAP benefit award letter shows they expire between application submission and closing, it could be impossible to receive a new award letter in the time frame needed without delaying the submission, Rural Development underwriting and/or closing. An additional challenge is that SNAP benefits can vary throughout the year, especially for seasonal workers, which means that the benefits statement may not accurately reflect the actual amount received. In these situations, the award letter and a statement of the past 12 months of the actual amount received, which is then averaged can be used to verify the monthly SNAP amount.

7. Any other revenue which a Federal statute exempts will be considered repayment income. This includes:

    - The imminent danger duty pay to a service person applicant or spouse away from home and exposed to hostile fire.
    - Payments to volunteers under the Domestic Volunteer Service Act of 1973, including, but not limited to National Volunteer Antipoverty Programs which include Volunteers In Service To America (VISTA), Peace Corps, Service

Learning Programs, and Special Volunteer Programs, National Older American Volunteer Programs for persons age 60 and over which include Retired Senior Volunteer Programs, Foster Grandparent Program, Older American Community Services Program, and National Volunteer Programs to Assist Small Business and Promote Volunteer Service to Persons with Business Experience, Service Corps of Retired Executives (SCORE), and Active Corps of Executives (ACE).

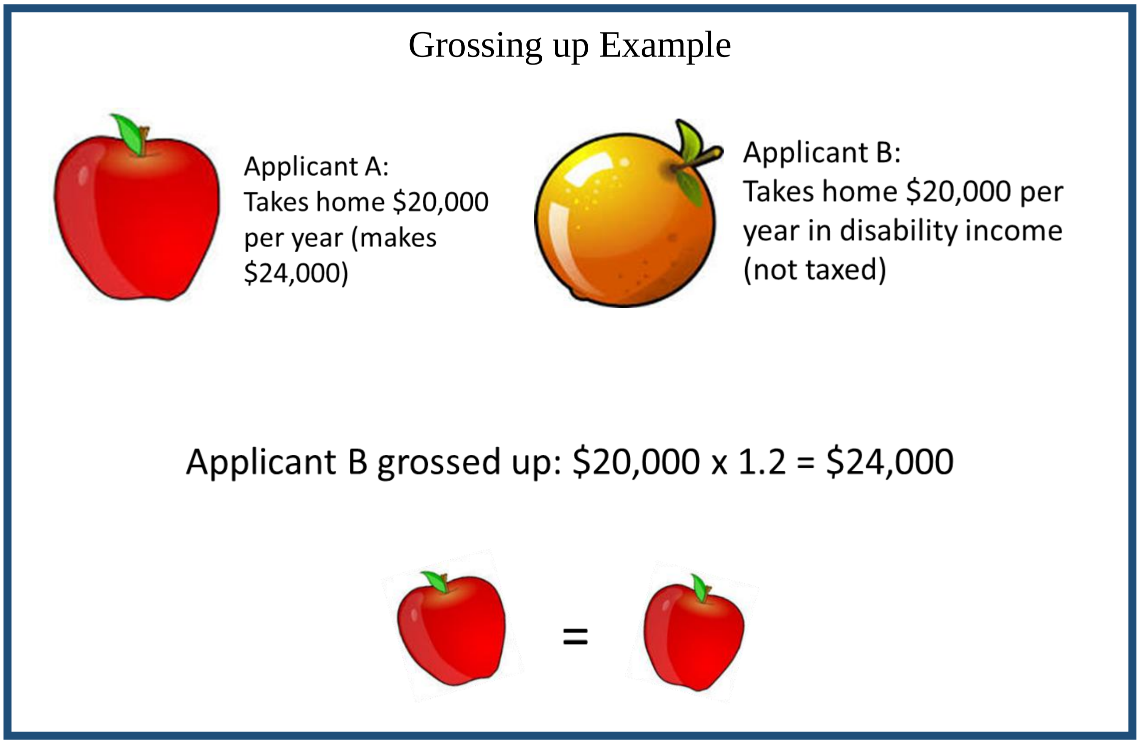
Income That is Never Counted

INCOME THAT IS NEVER COUNTED
FOR REPAYMENT OR ANNUAL INCOME ∅ (HB-1-3550, 4.3, C)

- Income received by live-in aides:
  - Family members are not considered live-in aides unless they are being paid by a health agency and have an address (other than a post office box) elsewhere.
- Income received by or payments for the care of foster children or foster adults who live in the household.
- Earned income of a minor (less than 18 years of age).
  - Unless the minor is the spouse of the applicant.
  - Child support or Temporary Assistance for Needy Families (TANF) is not considered the earned income of the minor.
- Only count $480.00 of earned income if an adult is a full-time student, but is NOT a borrower, co-borrower or spouse.
- Payments received on reverse amortization mortgages.
- Special-purpose payments (such as TANF).

Grossing Up

For Repayment Income only, non-taxable income that is considered stable and dependable and expected to continue for at least two years is required to be grossed up by 120 percent. The standard PITI/TD ratio limitations are based on the assumption that the income is taxable. Grossing up income allows income not subject to federal taxes, the amount of tax savings attributable to the nontaxable income will be added to the applicant's repayment income, examples include child support, Section 8 Housing Choice Voucher and Social Security benefits. For example, if child support payments are made as agreed and will continue for at least the next two years, they are considered repayment income and grossed up by 120 percent. However, if it was determined that the child support is not consistent or will end within two years it is not considered stable and dependable and not considered as repayment income. Social Security income is another typical source that is counted for both annual and repayment but is grossed up for repayment income only.



Adjusted Income

Adjusted income is used to:

1) Determine income eligibility
2) Determine interest subsidy
3) Determine interest charged during construction

Deductions for Adjusted Income

There are five deductions used to calculate adjusted income and not all households are eligible for all five deductions and some may not have any. This is why advertising an income limit in marketing materials for self-help can be so challenging, eligibility is actually based on the adjusted income, which could be significantly different than annual income. Because of this, you'll want to figure out adjusted income early in the application process to determine if the applicant is income eligible.

The Five Deductions from Annual Income Equals Adjusted Income

Adjusted income is annual income with the following deductions:

1. Dependent Deduction - $480 per qualified dependent

a) Not the note signer

b) Not the note signer's spouse

c) Age 17 or younger or disabled or 18 or older and a full-time student

NOTE: Foster children are not considered dependents

2. Qualified Child Care Expenses that meet all of the below criteria

a) Expenses not reimbursed to the applicant can be deducted. For example, the applicant has $500 per month in childcare expenses, but a state program reimburses $300 of these child care expenses each month. The unreimbursed amount of $200 per month can be deducted in the adjusted income calculation.

b) Child care expenses for children who are 12 years old or under

c) No other adult member of the household is available to provide child care and it enables a family member to work, seek employment or go to school

e) Expense deducted does not exceed income earned by the enabled household member

3. Elderly Household - Single deduction of $400 for the household if any party to the note is 62 or older or is an individual with a disability

4. Deduction for Disability Assistance Expenses

a) Identify the disabled person on the application and verify with physician the needed assistance expenses

b) Reasonable expenses in excess of 3 percent of annual income are deducted if:

   i) The disabled person or another family member is enabled to work

   ii) Expenses are not reimbursed from insurance or other sources

   iii) Expenses do not exceed income of the person who is enabled to work

      (1) Typical expenses:

         (a) Attendant care to assist with daily living

         (b) Special apparatus such as wheelchair, ramps, vehicle adaptation

Calculating Medical and Disability Assistance Deduction – Amount in excess of 3% of Annual Income

The Zimmerman family is having a note signer that is more than 62 years old and considered Elderly per RD regulations. The unreimbursed medical expenses of the entire household are $5,000 per year and they have an annual income of $30,000. They are able to deduct the medical expenses in excess of 3%, which for the Zimmerman family is $900 ($30,000 x .03). The amount deducted for the adjusted income calculation is $4,100 ($5,000 - $900).

5. Medical Expenses – Elderly Households (as defined above in #3) can deduct medical expenses of all household members that meet the below criteria.

a) Medical expenses that are not reimbursed by insurance or other sources

b) Medical expenses of the entire household that exceed 3 percent of the household's annual income. If the household also has disability assistance expenses these are combined when determining amount that exceeds 3 percent of annual income

c) Typical expenses include health care providers, hospitals, labs, clinics, medical or Medicaid and/or longer care premiums, prescription medicine, dental expenses, eyeglasses and exams, medical apparatus, attendant care, travel expenses to treatment

d) If the household qualifies, expenses for the entire household are considered

Assets

Assets that Generate Income

The applicant's assets can affect the Section 502 loan amount or the ability to qualify for a Section 502 loan. Many types of assets generate income that must be considered in calculating the applicant's annual and repayment income. The applicant may also be required to use some of the assets to make a down payment on the property. Assets fall into two categories retirement and non-retirement; only non-retirement assets are counted.

Applicants must provide net family asset information when they apply for a loan for the annual income calculations and whenever income re-certification is made. Applicants must supply sufficient information to determine which asset category each falls into and to compute the value of the assets and the actual income produced from non-retirement assets. For repayment income, actual income produced from assets received by the note signers are counted.

Non-Retirement Assets Include:

- Checking and savings accounts
- Investment accounts
- Equity in real property and capital investments
- Lump sum receipts
- Personal property held for investment
- Cash value of life insurance
- Revocable trust funds
- Assets in foreign countries

Retirement Assets

For the purpose of computing annual income, the current assets (retirement and non- retirement) of all

Assets Never Considered

Excluding these types of assets when considering annual income or down payment requirements will help safeguard the assets for their intended purposes and promote a healthy financial support system for the household when it does incur education and health care costs or enters retirement.

- The value of necessary items of personal property, such as furniture, clothing, cars, wedding rings and other jewelry not held as an investment, and vehicles specially equipped for persons with disabilities;
- ATVs, campers, RVs – these are personal property used for recreation
- Assets that are part of any business, trade, or farming operation in which any member of the household is actively engaged;
- The value of an irrevocable trust fund, or the value of any trust over which no member of the household has control;
- Term life insurance policies with no cash value and those with cash value;
- Interests in American Indian restricted land;
- The value of tax advantaged health, medical savings or spending accounts, and college savings plans; and
- For income calculations, any assets on hand that will be used to reduce the amount of loan.

applicants and co-applicants, as well as applicable net family assets, are considered. Reference Exhibit 4-1 for additional information.

Assets for Down Payment

RD considers the cash value of assets, which is the market value of the asset less reasonable expenses to convert the asset to cash. The cash value of these assets must be used toward down payment if they exceed the following limits:

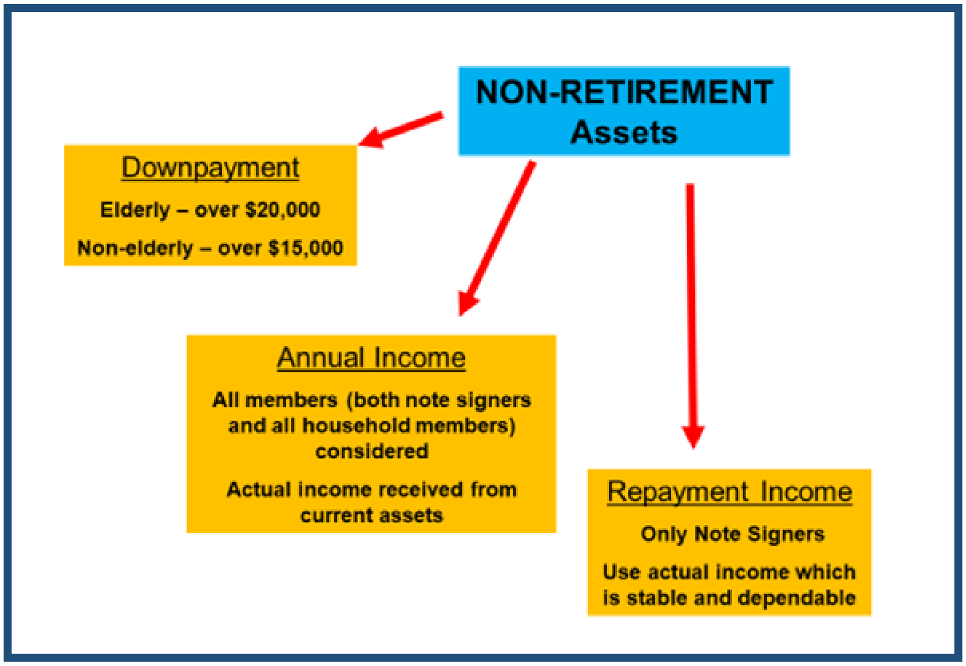
- Nonelderly Households - $15,000
- Elderly Households - $20,000

If a household has assets in excess of the above limits the excess can be used to:

- Make a down payment
- Pay closing costs
- Pay architectural, engineering, inspection, & testing fees (for new construction/ repairs)
- Establish the Rural Development initial escrow account
- Reduce non-housing debt
- Contribute to a retirement account
- Make purchases which are not considered as asset (see Exhibit 4-3, Appendix 2)

Assets for Income Calculations

Below is a diagram of the ways in which assets are considered:



Four Methods of Calculating Income

When calculating income, it is important to interpret the information correctly based on the situation of each applicant. The income documents provide a snapshot in time that is used to project the next 12 months. Because there are countless variations of income for applicants it is important to understand both the income from the previous year and the current income as you project forward. Rural Development has four methods of calculating income that are used to determine which method to recommend that provides the best projection for the next 12 months. Certain types of income and certain circumstances do not lend themselves to certain calculation methods. For example, monthly income like social security need not be calculated on the YTD method. Pay stubs from early in the year might not reflect seasonal overtime and in this case using tax returns for the historical method is most appropriate. If you decide not to even complete certain income calculation methods, you should clearly explain your rationale in the notes section of the 4-A.

The selection of which method must be carefully deliberated and may require additional verification. Different methods may be used or may be more appropriate depending on the type of income. For example: One applicant with two income sources—salary and commission. Each needs to be looked at separately, possibly resulting in different methods for each source. In the rare situation when the four methods produce figures that are very different and one figure is not clearly the most representative, an average of the resulting figures may be used. Once you've completed the four calculation methods, you will need to decide which one most accurately depicts the applicant's projected income and explain why you chose the one you did in your loan narrative and on the notes section of the 4-A.

If there are any declining income trends, especially for repayment income, you must carefully document it on the 4-A. A written statement from the applicant explaining the decline will also assist in interpreting the income documentation and project the coming 12 months. Rural Development will carefully review this in their underwriting analysis.

Selecting the appropriate method is important, for example selecting the lowest figure is NOT acceptable and may result in unauthorized assistance because the applicant receives too much subsidy. Yet over estimating could result in a mortgage amount that is beyond the applicant's ability to repay.

Four Methods

1. **Straight-based:** The gross benefit or wage is converted to annual equivalent. This is typically calculated by taking the hourly rate and multiplying it by the typical weekly hours, bi-weekly, monthly or annual hours. This income method is typically best used when the applicant has a fixed salary or a fixed wage/number of hours and typically does not have overtime or bonus income.

2. **Average:** The gross benefit or wage for last 30 days is averaged, then converted to annual equivalent. This method is best when there is some variation in hours and overtime from paycheck to paycheck with a 30-day period. However, it doesn't work when there are significant variations during different times of the year.

3. **Year to Date (YTD)**: Gross YTD earnings or benefits divided by number of days, then multiplied by 365. This is a particularly good method later in the calendar year as it averages all of the variations in pay for a longer amount of time than just 30 days.

4. **Historical:** Income from previous year's tax return. It is important to use the employment income from Box 3 on the W2, along with other sources, such as

unemployment, which are also included in the return. This method is recommended for seasonal employment. For self-employment, tax returns are a required component in calculating annual income.

RD 4-A Income and Payment Assistance Calculator

Rural Development has created an Income and Repayment Assistance Calculator using an excel spreadsheet. This calculator allows loan packagers to input information on all four methods of calculating income, including grossing up for nontaxable income and the maximum amount of SNAP benefits to be included in repayment income. The packager then chooses its recommended method using the drop-down options of—annual (A), repayment (R), both (B) or none (…) for each method of calculating. This spreadsheet is updated regularly and can be found on USDA Rural Development's website along with a tutorial on completing the 4-A spreadsheet. You will submit the 4-A as part of the loan package, with the goal of Rural Development agreeing with your income determinations.

Income Verifications

Third party verifications are required for every source of income and many of the deductions for adjusted income. The Rural Development HB-1-3550 Paragraph 4.3 includes an extremely useful chart on sources of income and deductions and the preferred and alternative sources of verification. For example, for seasonal employment the preferred source is tax returns, but for regular wage income paystubs are the preferred source. Rural Development does not require or recommend verifications of employment; however, these may be requested if paystubs or earnings statements are unavailable or inconsistent (see Chapter 6 of this guide).

Determining Household Size

The income limits are adjusted by household size; therefore, one of the first steps in determining eligibility is to determine and verify the size of the household. Households can include unrelated individuals and/or be multigenerational households which include grandparents, children and grandchildren or two adult sisters and their children living or proposing to live together may be determined to be a household. The applicant(s) will list all household members on their RD Form 410-4 Loan Application (loan application), which will be the basis for determining income calculations and eligibility. There are no requirements that the household members be related or that they have lived together in the past, however, you need to explain how the subsidy is calculated based on the household as described on the application. The goal is for successful homeowners, so although it is not a requirement that the household members remain consistent the subsidy will be impacted based on changes in the household size and income at the time of annual re-certification.

Some households may include live-in aides, the children of live-in aides, foster adults or foster children who are not considered as household members for the purposes of determining household size and income eligibility. A child who is subject to a shared-custody agreement in which the child resides any portion of their time with the household can be included as part of the household if they are included on the loan application. Another example is whether to consider an adult student living away from home as a household member, this is the applicant's decision as reflected on the loan application, assuming they are and will be a member of the household.

Determining Household Income as Percentage of AMI and Income Eligibility

Once household size and income information has been established and verified, the packager will determine eligibility by using the most recent Rural Development income limits, adjusted for family size and by geographic area (county or metropolitan area). Rural Development uses an income banding method for incomes by household size. Households of one to four members all have the income limit of a four-person household and those of five to eight members all have the income limit of an eight person household. For households with more than eight people, you will add 8 percent of the four-person limit for each person starting with the ninth person. For example, to calculate the 80 percent AMI for a 10-person household in Madison County you would:

- Start with 80 percent AMI for 8 people, which is $69,552
- Then calculate 8 percent of the 4-person 80 percent AMI → $52,700 x .08 = $4,216
- Add $4,216 for the 9th and 10th person, which equals $77,984

Partially due to income banding, Rural Development's income levels differ from HUD's, so be aware if you are using HUD funding (i.e. SHOP) with any part of the project. Rural Development's income limits are included in the 4-A and will populate automatically once you insert the county and state. The income limits are updated annually and are available on Rural

Development's website. Three different income limits are used in discussing Rural Development 502 Direct Loans: very low-income, low-income, and moderate-income. See the income map for details: https://www.rd.usda.gov/sites/default/files/RD-DirectLimitMap.pdf.

CHAPTER 4

BORROWER CREDIT

This chapter correlates with RD Handbook 1-3550 Chapter 4.

Steps for the Packager:

1. Order applicants credit report and review for accuracy and/or errors
2. Use the Credit History Worksheet as a tool to determine if credit is acceptable
3. Identify if nontraditional sources of credit are necessary
4. If necessary, evaluate indicators of unacceptable credit
5. Document anomalies, exception requests and letters of explanation, if necessary
6. Address credit in the loan narrative

Key Concepts

The key concept to evaluating a potential borrower's credit is evaluating their ability and willingness to pay their obligations.

- Ability = do they have the income to pay
- Willingness = do they pay as agreed

Ability has to do with the applicant's available, reliable income and considers whether the applicant has adequate income to repay their debt obligations from stable income source(s). Willingness on the other hand means that the applicant not only has funds available but is willing to use those funds to pay their creditors, as demonstrated on the credit report. In other words, you could be a millionaire with more than enough ability to pay your bills, but if you choose not to pay those to whom you owe debts, then you don't show a willingness to do so.

You'll need to evaluate the credit history for the last three years for each person that will be on the note, the applicant plus any co-applicants. This includes a separate credit evaluation for each person, even if they're married applying jointly. In each case, you evaluate the individual's credit separately. For some debt obligations (such as a significant delinquency), a scope greater than three years may be considered.

Credit reports are used to determine if an applicant has a recent history of making payments as agreed, are they consistently and dependably making their payments. In order to do this, you'll need to run a credit report or have the potential applicant run their free credit report. The free credit report will work, but often does not contain a score, which can make your job more challenging. And while eligibility is not based on a credit score, i.e. there's no magic credit score or number that makes them eligible or ineligible, it is an important component in your evaluation of the applicant's financial capacity. In fact, not having a credit score at all could be a good thing, this means they don't owe anyone anything.

The credit report you run will be included in the application package, but Rural Development won't ultimately use it for their eligibility determination. Rural Development runs its own Tri-Merge credit report and *cannot* adopt the one you ran. If the applicant's credit score dips below 640, from the time you run their credit to the time Rural Development runs their report, this will not be held against you, however it does mean Rural Development will be completing a full credit analysis for the applicant.

Getting Credit Reports

Some grantees sign up to run their own credit reports, this can be a daunting process because they are basically approving your organization, as they would a bank, to handle the credit reports. If you are Housing Counseling Agency, you may find it easier to get authorization to obtain credit reports and these are ideal for your purposes because they are usually soft hits to their score. If you contract to run your own credit reports, look carefully at the contract, this is where agreements are made on things like, can you give the applicant a copy of their credit report? Is it a soft pull that won't affect their credit score? (Not usually.) And how much will it cost? You'll also need to decide who's going to pay for this credit report, your organization or the applicant? Usually these reports cost between $15 and $25 per report. The applicant will need to pay for the Rural Development Tri-Merge credit report when you submit their packaged application, which will also cost the applicant a nonrefundable fee of $25 per application.

If you have the applicant run their free credit report, they can obtain a free credit report by calling 1-877-322-8228 or logging into http://www.annualcreditreport.com. By law, individuals are entitled to receive one free credit file disclosure every 12 months from each of the nationwide consumer credit reporting companies – Equifax, Experian and TransUnion. Sometimes the reporting companies require the inquirer to pay an upcharge to get the credit score, which is helpful for your analysis but not required. If you don't have a credit score, it may just mean a few more steps as you're packaging. By requesting one free credit report every four months from different consumer reporting companies (Trans Union, Equifax and Experian); consumers can get free credit file every three months. Because different credit reporting companies report different credit files, this will give consumers the opportunity to check for errors or omissions in their credit file. This one report every four months check on credit is especially useful from initial intake to application as it shows improvement made if the applicant is working on improving their credit and also any new negative credit that should immediately be addressed.

It is important to advise applicants that only one website is authorized to fill orders for the free annual credit report entitled under law: **annualcreditreport.com**. Other websites that claim to offer "free credit reports," "free credit scores" or "free credit monitoring" are not part of the legally mandated free annual credit report program. In some cases, the "free" product comes with strings attached. For example, some sites sign visitors up for a supposedly "free" service that converts to one with a charge after a trial period. If consumers don't cancel during the trial period, they may be unwittingly agreeing to let the company start charging fees to their credit card or bank account. Some of these "imposter" sites direct visitors to other sites that try to sell something or collect personal information.

The site annualcreditreport.com and the nationwide consumer reporting companies will not send an email asking for personal information. If you get an email, see a pop-up ad, or get a phone call from someone claiming to be from annualcreditreport.com or any of the three nationwide consumer reporting companies, do not reply or click on any link in the message. It's probably a scam. Forward any such email to the FTC at spam@uce.gov.

If you go to www.freecreditreport.com! This website will ask for a bank account or credit card and charge monthly for their service. This free credit report will cost $$$!

Reviewing the Credit Report

Never assume that any one source for credit information is better than any other. All are needed to determine creditworthiness. Begin with the credit report. When it is received, review it carefully.

- ✓ First check to see if the credit report is for the correct person. Compare the name, address, and Social Security number on the credit report with that on the application. If they do not agree, get clarifications from the credit reporting agency and the applicant before proceeding.
- ✓ If provided, compare the employment information and rental data from the credit report to the application.
- ✓ Compare the credit report to the application to see if the debts on the credit report are the same as those listed on the application. There may be accounts on the credit report that aren't on the application because the applicant simply forgot or accounts on the application that aren't on the credit report because some creditors don't furnish information to a credit repository. In those cases, the applicant will need to follow the credit reporting agencies requirements for adding or changing information on their credit report. This request will need to be mailed to the creditor directly and disputes will need to be settled prior to application submission.
- ✓ Is the applicant responsible for the trade line or an authorized user? An authorized user account may not be considered when determining the applicant's creditworthiness unless the applicant provides supporting documentation to demonstrate that they have made the monthly payments for the past 12 months.
- ✓ Compare the account numbers and current balances and monthly payments.
- ✓ Check for any judgments, charge-offs, or collections against the applicant.
- ✓ Check Public Records. Actions such as divorce actions, garnishes, suits, and bankruptcies may need to be explained or further documented by the applicant.

- ✓ Are there any recent inquires? If there are several inquiries, question the applicant to determine if other credit has been applied for and if there were any rejections. These may also need to be explained by the applicant.

Reading Credit Reports

While each of the three credit reporting organizations has its own format, most of the important information is self-explanatory. The top half of the page is background information such as name, address and employment. The second half lists information about accounts and payment history. This second half has variations among the three agencies.

At the end of the reports you will find a public records reference showing any disputes between the consumer and creditor that was settled in small claims court. This is followed by a summary of the consumer’s side of the dispute, based on an explanation that the consumer provided to the credit bureau.

There are two types of accounts listed on a credit report – individual and joint. The individual account indicates that the person’s name on the file has sole use and responsibility for payment of the account. A joint account means that two people use the account, and each is liable for payment. This is true even if a divorce decree makes one spouse responsible to the other for paying off the joint account (because creditors are not a party to the divorce decree). No matter where you obtain a credit report, it is highly recommended you study its reporting codes, format and how to read it. The codes and layout are different for each agency. These instructions are usually available on the reporting agencies websites and are critical to reading the report. Also check for videos or other training tools from the reporting agencies, as these are extremely helpful in reading their report.

There are three types of accounts typically used by credit grantors, “installment”, “revolving” and “open 30-days” each refer to types of payment arrangements or accounts. In an actual report, the initials “I”, “R”, or “O” will be used.

- In an **installment credit agreement**, a consumer signs a contract to repay a fixed amount of credit in equal payments over a specific period of time. Automobiles, furniture, and major appliances are often purchased on an installment basis. Personal loans are usually repaid in installments as well.

- In a **revolving credit agreement**, a consumer has the option of paying in full each month or of making a minimum payment based on the amount of the balance outstanding. Department stores, gas and oil companies, and banks typically issue credit cards based on a revolving credit plan.
- In an **open 30-day agreement**, a consumer promises to repay the full balance owed each month. Travel and entertainment charge cards and charge accounts with local businesses often require repayment on this basis.

How to correct errors!

The applicant's credit file may contain errors that can affect their chances of obtaining credit. Under the Fair Credit Reporting Act, they are entitled to have inaccurate or incomplete information corrected without charge.

If the applicant disputes information in their report:

- They must contact the credit bureau and explain the dispute and the dispute must be resolved prior to application submission to Rural Development.
- The credit bureau must reinvestigate it within a "reasonable period of time" unless it believes the dispute is "frivolous or irrelevant."

To check on the accuracy of a disputed item:

- The credit bureau will ask the creditor in question what its records show. If the disputed item is on the public record, the credit bureau will check there instead.
- If a disputed item cannot be verified, the credit bureau must delete it.
- If an item contains erroneous information, the credit bureau must correct it.
- If the file shows accounts that belong to another person, the credit bureau would have to delete them.

If the credit report showed that the applicant was late in making payments but failed to show that the applicant was no longer delinquent:

- The credit bureau would have to show that the applicant is no longer delinquent.
- The credit bureau would also have to add information to show that payments are now current.

Also, at the applicant's request, the credit bureau must send a notice of correction to any creditor who has checked the applicant's file in the past six months.

If the reinvestigation does not resolve the dispute, the Fair Credit Reporting Act permits the applicant to file a statement of up to 100 words with the credit bureau explaining the applicant's side of the story. Employees of the credit bureau are often available to help the applicant word their statement. The credit bureau must include this explanation in the report each time they send it out.

Reliability and Credit Scores

When reviewing the credit report, you want to first determine if it is an acceptable credit score. The way this is done is by looking at the number of scores on the report. If the applicant has at least two credit scores on their credit report, the score is considered reliable regardless of how many trade lines are on the credit report. You use the middle numerical score if three scores are listed, or the lower score if only two are listed. If there is only one score listed, it is not considered reliable. Credit scores are used to reduce the time necessary to conduct credit analyses and Rural Development has determined that the credit reporting agencies formula for assigning the scores already takes into account trade lines, payment history, use of credit, etc. An applicant's credit record doesn't have to be perfect; if an applicant's overall credit record demonstrates an ability and willingness to repay obligations.

Unreliable Score or No Credit Score

The most common reasons for an applicant to have no score or only one score is that they have limited traditional credit trade lines, they paid off all their debt years ago or they just haven't taken out debt. For applicants who do not use traditional credit, or that have a limited credit history, you must develop a credit history from at least three sources. However, only two sources are required if one of those is a verification of rent or mortgage payments. Developing a credit history in this situation is most often accomplished through nontraditional sources of credit (see Chapter 6 of this guide). A combination of traditional and nontraditional sources may be used to develop the credit history, and the non-traditional payments should have been made for at least 12 months within the past 24 months from the date of the credit report.

Reliable Score Over 640

If the credit score is deemed acceptable, is more than 640, and the applicant has no outstanding judgments from the U.S. in federal court and no significant delinquency, these applicants are automatically classified as having acceptable credit histories regardless of what is listed on the credit report. No consideration will be given to the number of opened and active trade lines on the credit report. The handbook makes it clear that to avoid potential disparate treatment, additional credit analysis is not appropriate. This means you will not use Exhibit 4-4, *Indicators of Unacceptable Credit* (Appendix 2), you will not need verification of rental history and you will not look at alternative credit. An applicant could even have multiple collection accounts listed in the credit report but because they aren't subject to review using Exhibit 4-4, these are acceptable and nothing needs to be done with them (i.e. pay them off, etc.). You have everything you need, and no further analysis should be conducted.

An applicant with significant delinquency (see Significant Delinquency later in this chapter) on their credit report, even with a reliable credit score of 640 or higher, will be subject to further analysis of the report's contents, as if their score were under 640.

Reliable Score Under 640

If the credit score is 639 or lower, you will need to conduct a full credit analysis. Start by reviewing the credit report, if it shows at least three trade lines that have been open and active for at least 12 months during the past 24 months, the applicant has enough trade lines and you will not need to obtain more. If the applicant does not have traditional credit, or not enough trade lines, you'll need to develop a credit history from at least three sources but, if one of those is a verification of rent or landlord verification, you'll only need two. The landlord verification is required and is double weighted. You'll send RD Form 1944-60 *Landlord's Verification*, as long as that landlord isn't a relative (Appendix 4), review the accounts on their credit report to determine if they have enough open and active trade lines, and review Exhibit 4-4, *Indicators of Unacceptable Credit* (Appendix 3).

You'll also be able to use a combination of what's on the credit report and nontraditional credit sources. For example, an applicant has a credit report with one trade line that's been open and active for at least 12 months, you can combine that with the landlord's verification and have enough information. If the landlord verification is not available, you would need to gather two nontraditional sources for this example.

Obtaining Nontraditional or Alternative Credit

Alternative credit or nontraditional credit is used when the credit report is not deemed reliable because there is limited or no established credit on the applicant's credit report. A total of three credit sources (a combination of traditional (from the credit report) and nontraditional) are needed UNLESS one of the credit sources is a verification of rent or mortgage payments, then only a total of two sources are needed. Verifications from family members do not count.

Nontraditional credit references DO NOT offset adverse credit reflected on the Tri-Merge. For instance: if the applicant's score is 580, with three trade lines in collection (three indicators of unacceptable credit) and upon reviewing these items using the Credit History Worksheet it is determined that they are adverse credit which cannot be waived, do not obtain alternate credit references. They won't change anything. Additional references, even if they show a good repayment history, would not offset the adverse credit already identified. Conversely, if the applicant's credit report was deemed reliable (at least two scores and over 640) there would be no reason to obtain additional nontraditional credit references, regardless of the number of trade lines in the credit report.

For those needing additional trade lines that are nontraditional, you will send to those nontraditional creditors indicated in the application or by obtaining cancelled checks, money order receipts, billing statements, and/or payment history printouts to establish the payment history. Which one is used is determined by what's available for that creditor. If you are obtaining payments histories from the creditor, the forms should be accompanied by a preaddressed, pre-stamped envelope and Form RD 3550-1, Authorization to Release Information (Appendix 5), which authorizes the respondent to release the information.

The payment history should be in the applicant's name and cover 12 months within the past 24 months from the date of the credit report. Payments that are auto-debited from the applicant's checking account, are the same as if they were paid directly and are acceptable; it still shows a willingness and ability. Payments that are made by someone else or reimbursed by another party, like an employer paying medical insurance or child care reimbursement by the state, are not acceptable. Payment installments (such as quarterly or annually) can be considered when verifying nontraditional credit sources. When other payment installments are used, the length of the payment history should be adjusted accordingly. If the payments are made quarterly, verify that the last four payments were made. If the payments are made annually, verify that at least the last two payments were made.

Sources of Nontraditional Credit

Always start with the preferred in the order listed and go down the list if the previous are not applicable or available:

Preferred:

- Rental payments
- Utility/internet/cell phone/cable TV payments
- Insurance (medical, auto, life, renter's, etc. as long as it's not reimbursed or paid for by another source, such as when an employer pays medical insurance, this would not be acceptable)
- Personal loan with terms in writing supported with canceled checks (cannot be a relative of the applicant)

Alternative:

- Payment to child care providers (cannot be a relative of the applicant)
- Department, furniture, rent-to-own stores, etc.
- School tuition

Using Exhibit 4-4, Indicators of Unacceptable Credit

Indicators of Unacceptable Credit are just that, indicators. These are not a list of items that would automatically make someone ineligible, this is a tool for conducting further analysis. And there aren't any magic numbers, for example, if they have two of any of these that wouldn't mean they aren't eligible, it's just a tool. It may be that the cause of bad credit was beyond the applicant's control, for example they were in a car accident and paid as agreed before and after the accident but couldn't pay while they were hospitalized. It is however, important that you be familiar with Exhibit 4-4 and understand what those indicators are. Exhibit 4-4 closely mirrors the Credit History Worksheet (described later in this chapter) where knowing the indicators will be important. For example, you need to look at 24 months rental history, however if there are no other indicators of unacceptable credit, you need to only analyze 12 months. If it's something beyond the applicant's control, ask the applicant to provide a credit explanation letter and document the relationship between the adverse credit and the circumstance. Blanket statements like they didn't know they owed it are not acceptable documentation. Exhibit 4-4, Indicators of Unacceptable Credit can be found in Appendix 3.

Significant Delinquency

A significant delinquency indicates there is a high level of risk that the applicant may be unable and/or unwilling to handle their mortgage payments. This does not mean they are automatically ineligible. If a significant delinquency exists, the applicant will not be able to use the streamlined credit analysis and is subject to a full credit review. An outstanding collection, while an indicator of unacceptable credit, is not considered a significant delinquency, significant delinquencies are as follows:

Significant Delinquency is not subjective, it is specifically, and only, the following.

1. Chapter 7 Bankruptcy

A Chapter 7 bankruptcy, also known as liquidation bankruptcy, eliminates all of an individual's unsecured debt. Applicants with a Chapter 7 bankruptcy discharged more than 36 months prior to the loan application are not considered to have unacceptable credit as long as they have re-established good credit. Re-establishing good credit includes consistently making payments on time, not incurring additional or excessive debt, and keeping balances significantly below the credit limit. If the bankruptcy has been discharged less than 36 months from the date of application or if the bankruptcy was due to extenuating circumstances, and the applicant has been able to re-establish good credit since the factors leading to the extenuating circumstance were removed. The loan file must include the loan documentation requirements for making a credit exception using extenuating circumstances.

2. Chapter 13 Bankruptcy

A Chapter 13 bankruptcy is a repayment plan that protects individuals from collection action during the plan period, from three to five years, and discharges any unpaid balance at the end of the plan. The repayment amount is determined by the court based on the individual's income. An applicant with a Chapter 13 bankruptcy reported on the credit profile may be able to qualify for a loan if the following requirements are met:

- Successful completion of the debt restructuring plan. The completion date is the bankruptcy discharge date.
- Demonstrates a willingness to meet obligations when due for the 12 months prior to the date of application. The last 12-month payments made under the bankruptcy restructuring plan may be used to document the applicant's willingness to repay debt. This means that all required payments were made on time and for the amount agreed upon under the plan.

A Chapter 13 bankruptcy is not considered unacceptable credit, and a credit exception is not required, when the aforementioned requirements have been met. However, the applicant must obtain written permission from the Bankruptcy Court to enter into a financial obligation with the agency.

3. Significant Mortgage Delinquency

Significant mortgage delinquency is a foreclosure, deed-in-lieu of foreclosure, short sale, or mortgage charge-off that has been completed within the last 36 months. These are significant mortgage delinquency events that, when present in the credit report, drastically increase the risk of a loan and must be carefully considered in the loan risk analysis when reviewing the loan application. For any significant mortgage delinquency transaction, the packager must confirm that the applicant has been completely released from the previous mortgage liability and is not responsible for any deficiency judgement. The following describes the most common significant mortgage delinquency actions reported to the credit bureaus that are used as an alternative to a formal foreclosure because they reduce the time and cost of repossessing a property and borrowers avoid the public notoriety of a foreclosure:

- **Deed-in-lieu of Foreclosure**. In a "deed-in-lieu of foreclosure" transaction, the borrower voluntarily transfers the property rights back to the creditor in an exchange for a mortgage cancellation. These transactions are most common when the property subject to the potential foreclosure has positive equity or if the homeowner meets the requirements for financial hardship relief.
- **Short Sale**. Short sale is a term used to describe a sale where the debt owing against a property combined with the costs associated with the sale exceeds the

property's market value. Short sales are also known as pre-foreclosure sales because the lender has not completed the foreclosure process but plans to foreclose if the property is not sold by the homeowner under the terms approved by the lien holders. Depending on the short sale agreement, the applicant may still be responsible for the amount that "fell short" as a result of the short sale transaction. The loan deficiency remaining after the sale is, at times forgiven; however, this is not always the case and may result in tax implications.

- **Mortgage Charge-Off**. A mortgage charge-off is a debt classification used by creditors when they believe a mortgage debt is not collectible. This action does not mean that the debt is no longer valid or that it has been forgiven. An applicant with a mortgage charge-off reported on the credit report may still be responsible for the debt. If the significant mortgage delinquency was due to the applicant's failure to meet financial obligations, the applicant is not eligible for a loan for 36 months from the date the obligation was released. However, if the delinquency was due to extenuating circumstances, the applicant may be eligible for a loan if:
    - More than 12 months have elapsed between the date the applicant was released from the mortgage debt and the application date.
    - The applicant has demonstrated an ability and willingness to meet obligations when due for the 12 months prior to the date of application.
    - The circumstances leading to the delinquency are properly documented and justified.

4. Agency debts that were debt settled within the past 36 months or are being considered for debt settlement. Agency debts are debts to Rural Development.

Requesting Credit Exceptions

On occasion, it may be possible that a credit exception may be warranted. It may be that the applicant's credit history problems may have been outside of their control or there were extenuating circumstances, which are unlikely to reoccur. The applicant must provide a letter to explain the nature of the event that led to the derogatory credit and provide supporting documentation accordingly. Depending on the situation, there may be multiple exceptions requested, there is no maximum number allowed, it's based on each situation.

An exception may be considered in the following types of situations:

- **Reduced shelter costs.** The applicant's rental or mortgage payment history has been unacceptable, and the loan will significantly reduce the applicant's shelter costs, which will result in improved debt repayment ability. Anticipated utility cost savings due to energy efficiency improvements (e.g. furnace replacement, insulation, energy efficient windows, etc.) may also be considered a reduced shelter cost for an existing homeowner.
- **Temporary situation.** The circumstances that caused the credit problems were temporary in nature and beyond the applicant's control. Examples include loss of job, delay or reduction in benefits, illness, or dispute over payment of defective goods or services.
- **Benefit to the government.** The applicant is delinquent on a federal debt, and the Agency loan will allow the applicant to take actions that benefit the government. **This type of exception can only be made by the administrator.**

If an exception is being requested, you will explain the reasons why you think it should be granted in the loan narrative and a letter of explanation written by the applicant should be included with the submission. The letter of explanation should address, in detail, the events surrounding the credit problems and is evaluated along with other documentation in the application package during their review. This is the applicant's opportunity to explain details that will not appear on the credit report.

The letter of explanation should cover three areas:

1. What happened, how it was corrected, and the stability of the situation at the present time. The first part of the letter should identify and discuss the cause(s) of the problem. If credit difficulties were due to an illness/medical expenses, over-extension, lay-off, reduction in income, or marital situation, this needs to be outlined in the letter.
2. The second part of the letter should address how these problems were corrected. Include in the letter if the creditors were contacted and alternative payment arrangements were made. This is the applicant's opportunity to let Rural

Development know that they were responsible in handling their obligations to the best of their ability.

3. The third part of the letter should summarize the applicant's present situation and how they have learned from their past experiences. The letter should indicate to Rural Development how they are prepared to handle emergencies that may occur in the future. The conclusion of the letter is an opportunity to let Rural Development know how important becoming a homeowner is to the applicant. Every opportunity should be used to stress the positive – job stability, performance, review, career advancement, education, medical coverage, savings, etc.

Explaining Credit Blemishes

Not all letters of explanation will be to request a credit exception. Because Exhibit 4-4, Indicators of Unacceptable Credit, is not a list of items that would automatically make someone ineligible, but rather just a tool for conducting further analysis, writing a letter of explanation could help the Rural Development Loan Officer to understand the big picture. Remember, there's is no magic number in Exhibit 4-4, in this case you're not necessarily asking for an exception and don't need to look at the three criteria above, you're just making the picture complete.

Credit History Worksheet

The Credit History Worksheet (Form RD 1944-61, Appendix 6) is a tool for evaluating what credit will be considered and summarizing the contents of the credit report. Rural Development will utilize this form when reviewing applications that are not reliable or with credit scores of less than 640 and it resembles the contents of Exhibit 4-4, Indicators of Unacceptable Credit (Appendix 3). This form is completed by Rural Development and not required to be completed by you. However, in an effort to make your file mirror, as much as possible, what Rural Development needs, you may want to complete it. It is a useful tool that may help you too to pull out important areas to consider in the credit report. This form is the third tab on the 4-A spreadsheet, labeled RD only – 1944-61.

Addressing Credit in the Loan Package

When putting together your loan package, you'll need to include a copy of the credit report you reviewed in the file and address credit in the loan narrative. What was the applicants credit score, was it reliable, were there areas of concern, etc. If there are credit letters of explanation in the file, why are you including them? Tie the letters to the credit blemish you are trying to explain, don't assume the recipient will know what you are addressing.

CHAPTER 5

REPAYMENT ABILITY

This chapter correlates with RD Handbook 1-3550 Chapter 4, Section 5.

This chapter combines repayment income (Chapter 3 of this guide) and credit (Chapter 4 of this guide) to determine an applicant's eligibility and ability to repay the loan based on income and debt.

Steps for the Packager:

1. Calculate PITI and total debt
2. Calculate ratios
3. Determine payments on deferred debt and benefits received (SNAP, SSI, etc.)
4. Calculate payment shock
5. Address any compensating factors
6. Enter everything into the 4-A calculator

Income Ratios

Dependable income (repayment income) must also be adequate to meet repayment ratios. Meeting the ratio guidelines will show repayment *ability*. Income used for determining these ratios is the repayment income for the applicant and co-applicant, which includes any other member of the household who will be party to the note. Two ratios must be calculated for each applicant; the PITI ratio and total debt (TD) ratio. Applicants are considered to have repayment ability when they do not exceed the appropriate PITI ratios and the TD ratios.

PITI Ratio

PITI = Principal + Interest + Taxes + Insurance

The PITI ratio is calculated by dividing the monthly PITI for the proposed loan, by the family's repayment income.

PITI includes

- ✓ Principal
- ✓ Interest

- ✓ Taxes
- ✓ Insurance on the proposed loan
- ✓ If a participation loan is involved, PITI will also include the principal and interest on the participation loan

The PITI ratios for very low-income (VLI) and low-income (LI) applicants differ. For VLI, 29 percent is used; for LI, 33 percent is used. When the PITI ratio for families who are 60 percent of median income and below exceeds the maximum appropriate ratio, the applicant can be considered for a 38-year loan term assuming this is needed to purchase an eligible home in your area.

Total Debt Ratio

Total debt (TD) is calculated by dividing the family's total monthly debt by their repayment income.

Total Debt consists of:

- ✓ PITI for the proposed loan.
- ✓ Homeowner Association (HOA) and other assessments on the proposed property.
- ✓ Long-term obligations and installment payments that have a remaining repayment period of more than six months.
- ✓ Alimony and child support payments
- ✓ Other short term obligations that are considered to have significant impact on repayment ability
- ✓ The minimum monthly payment required for revolving credit card debts using the following applicable approach:
- ✓ 1) Use $0 if the credit report indicates no outstanding balance.
- ✓ 2) Use the minimum monthly payment as reflected on the credit report if the credit report indicates an outstanding balance and a minimum monthly payment. 3) Use 5 percent of the outstanding balance if the credit report indicates an outstanding balance but no specific minimum monthly payment or obtain a copy of the most recent billing statement that reflects the actual monthly payment and use that amount if lower.

- ✓ 4) If the credit report indicates an outstanding balance but the applicant indicates that it will be (or has been) paid in full, a monthly payment will not be used provided the Loan Originator obtains documentation of payment in full. Deferred debt
- ✓ Student loan debt
- ✓ Any recently obtained debt and terms that are not showing on the credit report yet

Ratio Caps	*PITI Ratio*	*Total Debt Ratio*
Very Low-Income	*29%*	*41%*
Low-Income	*33%*	*41%*

Total Debt Ratio cannot exceed 41 percent for both low- and very low-income families.

PITI & TD Ratio Sample Calculations

Try to complete both the PITI and TD ratios for the following three examples and determine if they meet the ratio guidelines.

<u>Example #1</u> - VLI

Monthly repayment income	=	$916.00
Monthly PITI for proposed loan	=	$274.00
Other monthly debt	=	$ 50.00

PITI Ratio =

TD Ratio =

Does this family meet the ratio guidelines?

<u>Example #2</u> - LI

Monthly repayment income	=	$ 1,956.00
Monthly PITI for proposed loan	=	$ 600.00
Other monthly debt	=	$ 250.00

PITI Ratio =

TD Ratio =

Does this family meet the ratio guidelines?

<u>Example #3</u> - VLI

Monthly repayment income	=	$1,500.00
Monthly PITI for proposed loan	=	$ 425.00
Other monthly debt	=	$ 250.00

PITI Ratio =

TD Ratio =

Does this family meet the ratio guidelines?

Answers to PITI & TD Ratio Sample Calculations

<u>Example #1</u> – VLI

Repayment income (monthly)	=	$916.00
Monthly PITI for proposed loan	=	$274.00
Other Monthly Debt Obligation	=	$ 50.00

PITI Ratio	=	29.91% over 29% ratio
TD Ratio	=	35.37%

In this example, the applicant's PITI ratio is over the limit and they do not meet the guidelines. Because this is related to their housing costs, you could work with the applicant to choose another house plan that costs less or maybe they could increase their income.

<u>Example #2</u> – LI

Repayment income (monthly)	=	$1956.00
Monthly PITI for proposed loan	=	$ 600.00
Other monthly debt obligation	=	$ 250.00

PITI Ratio	=	30.67%
TD Ratio	=	43.45% over 41% ratio

In this example the applicant is over the ratio in their total debt. Working with them to reduce their monthly obligations or wait until they've been paid down may increase their eligibility.

<u>Example #3</u> – VLI

Repayment income (monthly)		=	$1500.00
Monthly PITI for proposed loan		=	$ 425.00
Other monthly debt obligation		=	$ 250.00
	PITI Ratio	=	28.33%
	TD Ratio	=	45% over 41% ratio

In this example the applicant is over the ratio in their total debt. Working with them to reduce their monthly obligations or wait until they've been paid down may increase their eligibility.

Student Loan Debt

In Repayment Status

If the applicants' student loan is in repayment status, you must use the greater of the actual payment or one-half percent (.50%) of the total loan amount. However, if the applicant meets all of the four criteria listed below, you can use the actual monthly payment under the existing repayment plan, often called Income-Driven Repayment Plan (as verified by the lender) if:

Calculating Student Loans

Credit report lists student loan payment of $0 and a balance of $15,000

.5% of $15,000 = $75

Amount shown in TD is $75

(1) The loan is in repayment status.

(2) The applicant has a reliable credit score of 640 or higher.

(3) The applicant has no significant delinquency.

(4) The applicant's payment shock can be measured and is not more than 100%.

If all four conditions are met and the applicant who is responsible for the student loan has, for example, a $0 monthly payment because they are on an income-driven repayment plan, there will be $0 shown as the student loan payment and considered in the TD ratio.

Calculating Student Loans with an Eligible Income Driven Plan and Over 640 Credit Score

Credit report lists student loan payment of $0 /balance of $15,000 and credit score 645

Payment shown in TD is $0

If one of the above requirements is not met, for example they have payment shock, a waiver from the next Rural Development level supervisor may be sought if the overall risk assessment on the application warrants it. For example, an applicant has a credit score of less than 640 but everything else looks good. The packager will need to carefully document this request in the loan narrative.

Deferment Status

When an applicant's student loan is in deferment, they are not making payments, the higher of the monthly student loan payment listed on the credit report or one-half percent (.50%) of the student loan balance must be used in the TD ratio.

Repayment vs. Deferment

Student loans in repayment and deferment are calculated very differently, so you should encourage the applicant to research the best option for them. If an applicant meets the lenders eligibility requirements for an Income Driven Repayment Plan, they may decide that switching their loan status from deferment to repayment would be to everyone's benefit (for them and the lender). This is a decision the applicant will have to make because any Income Driven Repayment Plan is based on their income and will be different for everyone. Showing the calculation differences may assist in their decision making.

Non-purchasing Spouses and Community Property States

Generally, in a community property state, money earned by either spouse during marriage or all property bought with those earnings are considered community property that is owned equally by husband and wife. Likewise, debts incurred during marriage are generally debts of the couple. In community property states, you and Rural Development must consider the non-purchasing spouse's debt in the total debt ratio. Neither you nor Rural Development can order a credit report for a non-purchasing spouse; the spouse of the married applicant who will not be party to the note. The spouse must provide a copy, which can be obtained from a free source, or if they have exhausted their free options, they would need to pay for one. If a non-purchasing spouse in a community property state is unwilling or unable to provide a credit report, the application will not be considered complete.

Community property states include: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. Puerto Rico allows property to be owned as community property, as do several Indian jurisdictions.

Debt the Applicant Isn't Responsible For

Debt from which the applicant has not been released but can show another party has assumed the debt, should not be counted if you can document that the payments have been made by the responsible party for the past 12 months. For example, a divorced couple where a house and its payments have been assigned to the former spouse and they have been making the payments for at least 12 months, you would not need to count this debt in TD. To document this in your application package, include the judge's decree, or whatever applicable documents show that the former spouse is liable, and cancelled checks or the lenders statement showing that payments were made by the former spouse for the last 12 months. If the payments are not being made by the person responsible or proper documentation cannot be provided, this debt will need to be included in the applicant's total debt.

Payment Shock

Payment shock is important because we all ultimately want the homeowner to be successful. If the applicant is not used to making payments, or is making payments that are significantly less than what they will be paying with the proposed mortgage, they will experience some shock and may need to adjust their lifestyle (i.e. less going out to eat; getting in the habit of setting aside funds for home maintenance; and those initial purchases like buying curtains, furniture, lawnmowers, etc.). If the applicant is making rent payments to a relative, this will not count as a credit source, however it is recommended you include this on the 4-A calculator in their housing expenses and provide documentation if available (cancelled checks are preferred).

But understand, it’s up to the Rural Development Loan Officer whether to count it or not, and they may still have payment shock. But this allows Rural Development context and additional information for the overall package review.

The calculation is overall, rather gracious and isn’t considered payment shock until it exceeds double (more than 100%) of their current housing costs.

Calculation:

Total proposed PITI after subsidy ÷ current housing expense excluding utilities – 1

Example:

$920.00 (PITI) ÷ $400.00 (rent) = 2.30

Minus 1 = 1.30

This applicant has 130 percent payment shock

If an applicant would experience payment shock because they don’t have a history of making a similar payment (for housing) and will have shock in excess of 100 percent, additional risk layering (ratio waivers, credit waivers, Income Based Student Loan Payment Agreements, etc.) is not allowed without strong justification. Strong justification might be that they will experience payment shock based on rent alone, but they have a history over the past 12 months of setting money aside in savings (without using it). And when those funds in savings are combined with their current rent, they show an ability to successfully make their mortgage payments.

Compensating Factors

Compensating factors are strong indicators that the prospective borrower may be able to make larger regular loan payments than the ratio analysis suggests.

Compensating factors:

- ✓ Cannot ever be used to offset poor or unacceptable credit
- ✓ Must be recommended by the Rural Development Loan Originator

- ✓ Approved by the Rural Development Loan Originators next level supervisor
- ✓ Cannot be used with any other risk factors

Compensating factors must be clearly documented. Packagers may recommend and support a compensating factor, but all compensating factors must be approved by the Rural Development loan approval official's next level supervisor. This means you will have to clearly document the request, provide any supporting documentation and convince the loan officer who reviews your package because they have to convince their supervisor. Compensating factors include:

- Payment history - Rent payments presently paid (in excess of the proposed PITI) must be adjusted to mirror a mortgage payment (remove any utility allowance paid in the rent or by someone else)
- Savings history - Applicants with accumulated savings and a savings history that shows a capacity to set aside a larger-than average portion of income may be approved for a higher payment
- Job prospects - The handbook states that if an applicant has recently entered a profession in which they can expect significant pay increases, the Loan Originator may base repayment income on the anticipated future earnings of that applicant but, because the calculations are based on a snapshot in time, this will be difficult to establish
- Homes constructed under specific energy efficiency programs - Energy efficient homes built to exceed the prevailing International Energy Conservation Codes approved by Rural Development, allow for a ratio that may exceed up to 2 percentage points above existing thresholds when plans are approved prior to application submission. This is because they typically result in a 30 percent energy savings relative to other homes without the same energy efficient efforts. The applicable energy efficiency programs are listed in HB 1-3550, Chapter 4.

Other Considerations if the Applicant has Insufficient Income

Other considerations can be utilized if an applicant has insufficient income resulting in ratios that are too high and unacceptable, these can be used to increase their repayment income.

Additional Parties to the Note

The applicant may choose to have an additional household member apply who would also be occupying the property and party to the note for 33 or 38 years. Repayment income may need to be revised.

Cosigners

Cosigners do not reside in the dwelling and must have a total debt ratio that does not exceed 41 percent. This ratio will include the FULL NOTE RATE payment for the 502 loan, escrow payment, leveraged loan payment AND all of the cosigner's long-term obligations. This means they need to be able to individually qualify with all of their own debt, plus the full amount they are co-signing for and still ratio qualify. Cosigners cannot be used in the case of poor credit, they are only used when ratios are too high and additional income will lower them.

Putting Repayment Income in the 4-A Calculator

Once you've determined the sources and repayment income amount that best projects income for the applicant, you will enter this in the 4-A automated calculator choosing the source(s) of income from the drop-down options: annual, repayment, both or none, for each income calculation method. You will submit a copy of your completed 4-A calculator to Rural Development with your full package. If you have notes or comments, those can be included on the 4-A calculator in the "notes" section.

The most current 4-A calculator and a webinar tutorial on how to use the calculator are available on Rural Development's website. You'll want to frequently check their site to ensure you are using the most current version.

Addressing Repayment Income in the Loan Narrative

In your loan narrative, or the comments section of the 4-A calculator, you'll want to explain why you chose the repayment income sources you did, if there are any compensating factors or anomalies in the package. Is there debt you didn't count (maybe because it had a known end date), is there a non-purchasing spouse, etc. Between the loan narrative and the 4-A calculator, analysis should include any other relevant information for your particular applicant. It is not necessary to restate items from the calculator in the narrative, the narrative supplements the calculator.

CHAPTER 6

VERIFICATION AND SUBMISSION DOCUMENTS

This chapter correlates with RD Handbook 1-3550 Chapter 4.

Steps for the Packager

1. Initial collection of information utilizing a pre-application or intake form
2. Review intake documents to determine if potential participant meets basic program guidelines
3. Conduct an applicant interview, completing the Uniform Residential Loan Application (RD 410-4), Authorization to Release Information and collecting backup documentation and information
4. Determine if additional verifications will be needed and request nontraditional sources if necessary
5. Obtain Homeownership Education completion certificate
6. Review construction budgets and loan amounts for funding amount
7. Review Attachment 3-J for completeness
8. Obtain updated third-party verifications for submission
9. Submit full application package to Rural Development

This chapter focuses on the documentation for verification, and the submission of the loan application to Rural Development. At each step in the process you will need third party documentation to support each portion of the application. The person who processes the loan application is a critical player in the mortgage loan process. A strong loan packager is one who puts the pieces of the mortgage loan file together and builds the bridge between the borrower and the lender by carefully listening to the applicant and collecting the necessary information. This kind of loan packaging ensures that quality, well documented loan applications are submitted to Rural Development.

You should have an internal document you use throughout the packaging process to ensure you're gathering the information you need throughout the process (see sample checklist, Appendix 1). RD also has a checklist they've designed to aid in the submission process, Attachment 3-J, *Checklist of items to accompany the uniform residential loan application* (Appendix 7), which gives a broad-brush list of the documents that comprise a complete package. What's difficult about any checklist is that it cannot list everything for everyone. Just like financial information is different for every applicant, their life on paper is different. It would be difficult to list every possible circumstance, so your internal checklist will be helpful to prompt you for other documents.

What do I use to verify?

Verifications are a snapshot in time, what is happening right now and used to "back up" what the applicant has stated on their application. They have signed, under penalty of law, government fines and all kinds of horrible things, that what they have provided in the application is true to the best of their knowledge. The packager uses the application to determine what verifications are needed and which supporting documentation is needed per Rural Development's guidelines. For example, you're able to verify an applicant's application statement that they have been working full-time for the last year. Prior to that, they received unemployment benefits for a couple months. Verifying whether or not they still have unemployment benefits available isn't appropriate. Or consider an applicant who lists a previous employer, which can be verified with tax returns, no verification of employment should be requested to prove they no longer work there. It isn't helpful in making an eligibility determination.

The preferred verification sources are items that are prepared by a third party; sources that are readily available to the applicant. These are no longer the days of sending out written verifications and waiting for them to come back, and sometimes not returned at all. The preferred verification sources now are things the applicant would have available like paystubs, benefit award letters, bank statements, etc. Items like these, which are readily available, should be used instead of sending written verification forms.

In HB 1-3550 Chapter 4, Rural Development has a very useful table, Verification Requirements and Procedures Table that lays out the preferred sources for verification and the order in which you would request them. Seeking additional verifications from those other than the preferred, is not helpful. If for example, a benefit award letter is available and remains current, getting a written verification from the issuing agency should not be sought. Requesting additional information not required by Rural Development or necessary for determining eligibility, could even be construed as a civil rights violation. Keep in mind that your job is to determine the applicant's eligibility for the program only and not to include any additional information that is not required. For example, requiring a parenting plan when there is no deduction for child care expenses could be considered a judgmental request or questioning how the applicant cares for their children. Requesting documentation on medical conditions for the medical expense deduction can be viewed as a HIPAA violation when you only need to document the expense, not the reason for the medical reason for the expense. You must always be sure that you have a reason related to their eligibility when requesting information and also avoid any judgement or perceived judgement as the applicants are sharing significant confidential information with you.

Here are some of the most common verifications you'll likely be collecting, for the full list, see Rural Development's table in HB 1-3550, Chapter 4.

Verification of Wages, Salary and/or Employment

Preferred Source: Four consecutive weeks of Paystubs or payroll earnings. Usually this is two paystubs each covering two weeks, but it could also be one monthly check or four weekly checks. The stub must clearly identify the applicant, show gross earnings including Year-to-Date (YTD) and must be computer generated or typed. You'll want to make sure you are getting these periodically throughout the packaging process to watch for significant changes that could change eligibility. You'll also want to get the newest paystub(s) just prior to submission to ensure the "most recent" documents are being provided.

Acceptable Alternatives

1. **Electronic Verification** - If and only if, you are unable to verify income using the preferred source, the acceptable alternative in lieu of paystub(s) is electronic verification. Electronic verification needs to have all of the same information as

paystubs would, identifying information, covering the most recent four consecutive weeks and YTD income.

2. **Verification of Employment** - In the very rare occasion you cannot get paystub(s) or electronic verification, RD form 1910-5, Request for Verification of Employment with Form RD 1-3550, Authorization to Release Information, would be sent to each employer. Application processing should not be delayed if a third party does not respond to a request for information. In these instances, you should seek to obtain the most relevant information that can be obtained from the applicant. This may include, but is not limited to, evidence of deposits/withdrawals, copies of cancelled checks, etc. A Verification of Employment (VOE) would not be used to determine that the income is "likely to continue," if the applicant has paystubs and tax returns, that determination is made by analyzing the information presented.

   Oral verifications are conducted by Rural Development and are only obtained if the applicant has worked for the employer for less than a year or the verifications appear inconsistent or suspicious. Income information is not discussed during this verification. In addition, an oral verification would not be used to determine that the income is "likely to continue," if the applicant has paystubs and tax returns, that determination is made by analyzing the information presented.

Verification of Seasonal Employment

Preferred Source: Most recent federal income tax return, the prior year's W-2s and/or prior year's 1099- MISC statements.

Someone who works seasonally, whether farm labor or union member, may have multiple employers during the year so it is not feasible to obtain paystubs/VOE's from all of those employers, especially when they may change from year to year and they are not likely working for all of them simultaneously throughout the year. But it really will depend on the applicant. If they are seasonal, but always work for the same employer, then you MAY be able to obtain a paystub (if they are applying during the period when they are working). If they are applying during their period of unemployment, you won't be able to obtain a paystub. When a seasonal worker works for multiple employers and has periods of unemployment, it's just easier and more practical to obtain the tax returns and base income projections on those.

Verification of Childcare Costs

Preferred Source: Rural Development is looking for verification from a third party and if the applicant can provide evidence (verification) using information that they have on hand, that is acceptable. The entity needs to be identified (i.e. on letterhead) and verification such as a 12-month history of cancelled checks, billing statements, a service contract, etc. provided.

Acceptable Alternative

In the event that this source isn't available, you could send Verification of Child/Dependent Care Form to the childcare provider with Form RD 1-3550, Authorization to Release Information.

Verification of Regular, Unearned Income (e.g., Social Security, SSI, Retirement Funds, Pensions, Annuities, Disability or Death Benefits)

Preferred Source: Copy of the most recent award or benefit letter from the authorizing, or issuing, agency. Be sure to check the dates, if the award letter is more than 12 months old, you may need additional information (see HB 1-3550 Chapter 4) or if it's going to expire prior to application submission, you will need to get a new one from the applicant.

Acceptable Alternatives

The two most recent bank statements showing the amount of monthly benefits received and IRS Form 1099 for the previous year. You'll need to verify that the benefit shown on the bank statement reflects the gross amount of the benefit prior to deductions for items such as taxes, health benefits, insurance premiums, etc.

Verification of Child Support and Alimony

Alimony, child Support, or separate maintenance income does not need to be revealed if the applicant or co-applicant does not choose to have it considered for repaying the loan. While an applicant can choose to have this income excluded from their repayment income, this income must be reported to determine if the household's adjusted income is within the program's income limit. You'll need to enter this income appropriately, for annual, adjusted or repayment income, in the 4-A calculator.

Preferred Source: The applicant or household member must provide a payment history for the last 12 months from the court appointed entity responsible for handling payments. The average amount received will be used in the income calculations; add all 12 payments together and divide by 12.

Acceptable Alternatives

1. **Electronic Verification -** The two most recent bank statements showing electronic deposit of the monthly alimony and/or child support received **AND** a copy of the court appointed divorce decree or separation agreement (if the divorce is not final) that provides for the payment of alimony or child support and states the amount and the period of time over which it will be received.

2. **Divorce Decree** - If (**and only if**) a source of income was awarded in the decree, and there is not a court appointed entity responsible for handling payments, the applicant (or adult household member) may provide a copy of the divorce decree, separation agreement, or other document indicating the amount of the required support payments. If the applicant reports that the amount required by the agreement is not being received, the applicant must provide adequate documentation of the amount being received (i.e. copies of the checks or money orders from the payer, etc.) and certify the payments are being received or not received.

3. **Cancelled Checks** - If (**and only if**) there is not a court appointed entity responsible for handling payments and formal documents were never issued, support payments can be certified as being received or not received.

Landlord Verification

If an applicant has a reliable score over 640, you do not verify rent at all. Where applicable in the loan narrative and/or 4-A calculator (to calculate payment shock, etc.), you will use the rent information provided by the applicant on the 410 application.

Preferred Source: When a landlord verification is necessary (see Chapter 5 of this guide, Borrower Credit), send Form RD 1944-60. Landlord's Verification is to verify the applicant's past record of making rental payments for each landlord listed on the application for the past two years. Once received, confirm that the applicant has paid in a timely manner during the last 24 months and if this is in question, call to confirm with the landlord. Exhibit 4-4 specifies that a rent payment that is more than 30 days late is considered an Indicator of Unacceptable Credit, so a little digging can go a long way.

Acceptable Alternatives

If you are unable to reach the landlord or they fail to respond, application processing should not be stopped. In this instance, you should seek the most relevant information that can be obtained from the applicant to verify the information. This may include, but is not limited to, the rental agreement in combination with copies of cancelled checks, bank statements and/or money order receipts, etc.

Nontraditional Credit

You will need to establish a 12-month payment history by either sending Form RD 410-8, Applicant Reference Letter (Appendix 5), to the nontraditional creditors indicated by the applicant or by obtaining canceled checks, money order receipts, billing statements, and/or payment history printouts from the creditor. You'll need to make sure you're able to determine if payments were made as agreed, general statements such as "satisfactory" or "in good standing" are not sufficient to establish a satisfactory repayment history.

<u>Preferred Sources</u>:

- Rental housing payments
- Utilities (if not included in the rent payment) such as power, gas, water, sewer, etc.
- Telephone service
- Cable television
- Internet service
- Insurance payments (payroll deductions to pay for insurance premiums are not considered alternative credit) as long as they are not reimbursed by any other source

Acceptable Alternatives

Payments to child care providers (provided the provider is an established child care business and not a relative); school tuition; payments to local retail stores; storage units companies; payment arrangements for the uninsured portion of any medical bills; a history of saving by regular deposits resulting in a balance equal to three months of the proposed mortgage payments; and similar credit sources. Child support paid is not an acceptable source.

Gathering Documents for Verification

Basically, everything needs to be verified and you'll need these to be provided by the applicant during your meeting with them. Often, a grantee will have a list they provide to clients before meeting with them outlining everything they should bring in with them for a first meeting. Generally, this includes the following:

- ✓ Bring pay stubs for the past month (four weeks) for all working applicants
- ✓ Provide credit card account numbers, current balances, monthly payments and addresses
- ✓ If you have personal loans, credit union loans, or any other monthly installments, bring account numbers, balances, monthly payments and addresses
- ✓ For hospital bills, doctor bills, and any other medical bills, bring account numbers, balances, monthly payments and addresses
- ✓ If you receive child support and support is ordered through the courts, bring a copy of the actual court document. If support is received and paid voluntarily, bring a statement from the person who pays you
- ✓ If anyone in your household receives social security, bring a copy of the most current award letter
- ✓ Name and address of current and previous landlords to cover the past two years
- ✓ Copy of the last two years complete tax returns with all attachments and w2s
- ✓ If self-employed, copy of the last two tax return schedules (C, K, E, etc.) include YTD Business Expenses for the current year
- ✓ Your Driver's License and a copy of the Social Security Card is only needed if there isn't other evidence of the applicant's full taxpayer ID number. (if not a US Citizen, a Permanent Resident Alien Card front and back)
- ✓ Two most recent monthly bank statements of all accounts: checking, savings, IRA, 401k, etc.

- ✓ If using non-traditional credit verification, the contact information for landlords from the last two years, (Name, number, address, email, etc.)
- ✓ Documentation of student loan(s): monthly payment statement and any grant documentation (see Student Loan section). For full-time students (who are not a party to the note, include a copy of the transcript and the school administration's definition of a full-time student (usually readily available on their website)
- ✓ If you are divorced or separated, you will need to bring a copy of the legal documents
- ✓ Provide an employment history for the past two years of all household members. Included names and addresses that can verify employment
- ✓ Bring a statement from your childcare provider stating what they charge you for this service

Timelines

Timeliness in processing a loan application is critical. You and your organization have a lot at stake. To ensure this, a group coordinator must be well organized, thorough and aware of the age of all the third-party documents on hand in a package you are building for submission. This may mean you are getting multiple copies of documents to ensure you have the most recent at submission (i.e. paystubs). Documentation used to verify employment, income, assets, and deductions must be no more than 120 days old, or 180 days old for new construction (that's self-help) by closing date. The age of some documents isn't important because they remain unchanged, such as a divorce decree or tax returns. These types of documents are exempt from the document age restriction unless there is evidence that the applicant's circumstances have changed thus warranting updated verifications.

Homeownership Education

An approved homeownership education class must be completed within two years prior to the date of loan closing by any applicant that has not owned a home within the past three years. A copy of the certificate is included in the package. Rural Development has a specific list of required topics and approved national providers (see HB 1-3550 Chapter 3) and state offices maintain state specific providers.

Preference order for Homeownership Education:

1. Classroom, one-on-one or interactive video conference
2. Interactive home-study with phone counseling
3. Online counseling

The education fee may be included in the loan above the appraised value. If it is not possible for an applicant to attend a course in person, applicants can also use an online course, such as the eHomeAmerica online class, which allows for a local contact telephone interview/discussion. The cost is $75.00 for USDA applicants. To register, login to: eHome America at https://ehomeamerica.org/usda. Framework is another nationally approved online course, and it is also $75.00. Register at https://www.frameworkhomeownership.org/. Thirdly, Utah State University also offers online homebuyer education. Visit: https://extension.learn.usu.edu/ and select Home Buyer Education. The cost is $60 for the applicant and $5 for a co-applicant.

The homeownership education requirement should be discussed with the potential applicant at the very beginning and they should be encouraged to take it prior to entering into a purchase contract. But, if an applicant has not taken the homebuyer education course at the time of application submission, indicate this in your loan narrative and that it will be completed prior to loan closing.

Construction Budgets and Loan Amounts

By this point you have likely created and recreated budgets for your construction costs. You submitted one with your Section 523 (re)application and have likely made many adjustments to it since then as prices have changed. During this phase, it is not necessary to submit new budgets again, because you will when you submit property information. It is important to review the budgets to ensure they are accurate as possible because you will be requesting a loan amount in your loan narrative and 4-A calculator. The balancing act here is making sure you are requesting the proper funding amount for eligibility determination; will they qualify for enough to buy the house, but not too much so that your applicants cannot qualify.

Applicants for a self-help loan will be issued Handbook Letter 16 (3550), Eligibility of Self- Help Applicants (Appendix 9). The maximum loan amount they qualify for may be a higher loan amount than the actual cost of building a modest home using the self-help method.

The dollar amount to be inserted in the eligibility letter will be based on all closing costs and the following:

A. The average cost of the most recent group of homes built in the area by the self-help method with consideration given to known price increases or decreases in materials, labor, land and/or time of construction (unless the applicant qualifies for less); or

B. The average cost of the homes that are to be built by the self-help method as determined by detailed cost estimates of the plans and specifications prepared by the self-help grant organization, in consultation with the local Rural Development staff and/or Technical and Management Assistant (T&MA) contractor. Consideration will also be given to known price increases or decreases in material, labor and/or time of construction (unless the applicant qualifies for less).

Check for Completeness & Consistency

As a packager, some of your responsibilities will include being a detective! Searching through the application, verifications and all documents for completeness and continuity between the documents—does what the applicant said on the application match the bank statements, verifications, etc.

Loan Application – Start with a review of the loan application. This is Rural Development's Uniform Residential Loan Application, Form RD 410-4 (Appendix 10), or a current industry standard application form may be accepted when accompanied by the Agency's supplemental pages (6-10) of Form RD 410-4. Is there information that you need to process the loan request or are there questions that you have because of incomplete information. An application is considered complete for eligibility determination when the loan application packager submits a fully completed and signed uniform residential loan application and all the applicable items listed in on Attachment 3-J.

Verifications – As the verifications and documentation comes in, does the information on the verifications correspond to the information on the application? All verifications should be checked for **completeness** and for **discrepancies** from information provided by the applicant. Any discrepancies should be discussed with the applicant or the party who completed the verification and clarifications should be documented carefully in the loan narrative or where appropriate.

Employment – Paystubs should correspond with the information given on the application and the 4-A calculator. Do not make notations or explanations on the verification forms themselves. If any explanation is necessary due to a discrepancy, the applicant should do so in writing on a separate sheet or you should address it in the loan narrative.

Verification of Deposit – Check to see if the average balance differs greatly from the amount currently in the account. This will sometimes indicate that funds have been recently removed from or placed into the account. A statement should be furnished regarding any discrepancy in the balances. Look for any large deposits as these may show additional income the applicant forgot to mention (and these need a letter of explanation).

Credit Reports – You'll need to include the credit report in the loan package. Remember there is only past history to determine the applicant's character and their willingness to repay debts. Any credit explanation must be written by the applicant and include what caused the problem. It should state that the situation is not likely to occur again, and that good credit had been re-established.

Letters of Explanation – Ensure that you have the necessary letters of explanation needed to address gaps in employment, large deposits, etc. and written by the applicant.

Loan Narrative – Does your loan narrative address everything it needs to? (See Chapter 2 of this guide.)

Application Processing and Eligibility Determination

Once your completed application is submitted to Rural Development, the application will be reviewed for eligibility within 30 days.

Determination of Eligibility

If the application is determined eligible, you and the applicant should both receive a copy of the Certificate of Eligibility: Handbook Letter 16 (3550), Eligibility of Self- Help Applicants (Appendix 9). It is also helpful to receive a copy of the Rural Development Loan Officer's 4-A calculator or Eligibility Summary to compare figures. The more you know about how Rural Development calculates incomes, the closer you will be in the future.

Application Withdrawal

An application can be withdrawn by the applicant at any time, for any reason. This can happen because of a family change, job transfer, job loss or any one of a hundred reasons. The applicant will need to provide their request to withdraw in writing to Rural Development.

Reapplying After Denial

There is no waiting period to reapply after an applicant's application has been denied. They could reapply everyday if they wanted to. Hopefully, with your help and guidance, they will have corrected the reason for the denial before reapplying.

CHAPTER 7

SUBSIDY RECAPTURE

This chapter correlates with Rural Development Handbook 1-3550 Chapter 6 and Appendix 11 - Form RD 1-3550.

Steps for the Packager

1. Inform applicant of the recapture requirement at the time of application

2. Remind the applicant that at loan closing, the participant will sign and RD will review the Subsidy Repayment Agreement (Appendix 11 - Form RD 3550-12)

3. Remind applicant at conversion that if recapture is triggered, they should call National Financial and Accounting Operations Center (NFAOC) to start the process to determine recapture amount

Background

Payment assistance, also known as subsidy, is granted to eligible very low- and low-income homeowners who obtain a Single Family Housing Section 502 Direct Loan from USDA Rural Development. The borrower signs RD Form 3550-12, Subsidy Repayment Agreement, at loan closing. The agreement outlines the subsidy repayment terms, the requirement to repay all or a portion of the subsidy received over the life of the loan (i.e., subsidy recapture), and how subsidy recapture is calculated. The security instrument (Deed of Trust or Mortgage) contains a provision making the subsidy a lien against the property. The lien will not be released until subsidy recapture is paid in full.

How is Subsidy Recapture Calculated?

While subsidy recapture formulas have changed over the years, under the current formula, the maximum amount of subsidy recapture which must be repaid is the lesser of the total dollar amount of subsidy received or 50 percent of the property's value appreciation.

Value appreciation is based on the difference between: (1) the market value of the property at the time of loan pay off; and (2) amounts of prior liens, subordinate affordable housing products, the Rural Development loan being paid off, principal reduction paid at note rate, reasonable closing costs, certain capital improvements, and the borrower's original equity in the property when the mortgage loan was originally closed.

Other factors, such as the term of the loan, average interest rate, percentage of outstanding balance of open loans, and whether all loans subject to recapture are being paid off, are also considered in subsidy recapture.

In the event of default (foreclosure or deed in lieu of foreclosure), the amount of subsidy recapture due is the total amount of subsidy received over the life of the loan.

When is subsidy recapture repaid?

The borrower must pay subsidy recapture when they transfer title or cease to occupy the property. If a borrower pays off the principal and interest of their loan and continues to occupy the property, repayment of the subsidy recapture amount can be deferred until the borrower ceases to occupy the property or transfers title. The security instrument securing the subsidy recapture amount may be subordinated to permit refinancing if Rural Development's lien position will be adequately secured. If eligible for deferral, and to encourage early payment, a discount of 25 percent of the subsidy recapture is offered if it is paid at the time the principal and interest is paid.

How can borrowers find out the amount of subsidy recapture to be repaid?

Borrowers can obtain an estimated, verbal pay off amount, including subsidy recapture, by calling USDA Rural Development's Customer Service Center Interactive Voice Response system at (800) 414-1226. Choose the "payoff information" option. Be ready to provide the estimated market value of the property, and estimated closing costs that may be incurred as the result of selling or refinancing.

Summary

As self-help grantees, it is important to explain the key components of subsidy recapture, however try to avoid getting too far into the details as it is impossible to predict the amounts that will be used at the time of recapture. Emphasize that they should contact Rural Development's

National Financial and Accounting Operations Center (NFAOC) to start the process to determine the recapture amount if and when one of the triggering events occurs: loan payoff, no longer occupying the home as their personal residence, or sale/title transfer of the home. They will then work with NFAOC to order an appraisal, the cost of which Rural Development covers, to determine the current value and value of any improvements. Depending on the triggering event, additional documentation may be needed to make the appropriate calculations, which NFAOC will discuss with them at that time. Also, reassure the owner builders that their original equity/sweat equity will be protected and that they will only be required to pay a portion of the appreciated amount, never more than 50 percent and never more than the actual amount of subsidy provided as long as they are not in default on their loan.

CHAPTER 8

PROPERTY SUBMISSION

502 Direct applications have two major components. The first is the applicant eligibility, which is covered in the previous sections. The second is the property eligibility, which is reviewed for program compliance and security for the loan. Typically, these are separate submissions, with the property submitted after applicants receive their certificate of eligibility from Rural Development. Some 523 grantees submit both eligibility and property sections at the same time for Rural Development determination of eligibility and underwriting, however this should be decided on the local level in consultation with your Rural Development loan approval official. (See Chapter 10 of this guide for further details on the pros and cons of a one or two step submission process.)

Steps for the Packager

1. Determine if the location is in a rural eligible area
2. Determine estimated value of lots and estimated value of completed homes and compare with lot value and area loan limit requirements
3. Secure land
4. Complete required environmental review requirements
5. Complete site infrastructure development if necessary
6. COE received and then prepare property document submission
   - Certified house plans
   - Site plan and possibly survey
   - Description of materials
   - Budgets
   - Closing Costs
   - Closing agent contact information (Title Company or Closing Attorney)
7. Submit to RD

502 Property Program Requirements

Rural Definition

The definition of rural is complicated due to changes made over the years and especially in the past 30 years after each of the past three censuses. It is recommended that you access the Rural Development website to determine which areas are considered rural in your serve area. The simplified definition is an area with populations less than 20,000, unless based on census data in the past 30 years, the area has increased but not in excess of 35,000.

Communities can be considered rural if they were considered rural prior to 1990 or between 2000-2010 with populations between 20,000-35,000, are considered rural in nature, and have a serious lack of available mortgage credit for low- and moderate-income households. (Yes, that was the simplified version.) This definition will be reviewed after the 2020 census and again it is recommended that you use the Rural Development website to determine if a site meets the rural eligibility requirement. It is recommended that you look up each lot you are including in your build group prior to purchase, since a lot on one side of the street can be eligible, while the lot on the other side is not.

Lots Requirements

As a 523 grantee, you will be identifying and likely purchasing and developing the lots prior to 502 application submission. Although you will have all of your lots identified prior to your 523 application, you should not under estimate the amount of time needed to complete your due diligence and Rural Development requirements prior to the submission of property documentation after applicants have received their Certificate of Eligibility (COE).

Rural Development's definition of modest lots includes lots that cannot be subdivided under local subdivision code and the value cannot exceed 30 percent of the total appraised value of the completed home. There are exceptions to the limitation of 30 percent of the value of the completed home, if the value is typical for the area, as evidenced by an appraisal and practices of other local lenders. If you believe your lots will exceed the 30 percent amount, you should discuss this with your Rural Development loan approval official prior to purchase to ensure that this will not be an issue when the loan applications are submitted. Finally, lots cannot include land that is used principally for income producing purposes. For example, vacant land or properties used primarily for agricultural, farming or commercial enterprise are ineligible.

Lots must also include:

- All weather road maintained by public entity or homeowner's association
- Water and wastewater disposal with continuous service and affordable rates that meet the Safe Drinking Water Act and Clean Water Act
- Not in 100-year Flood Plan (see details in Environmental Section)
- Comply with all zoning and restriction requirements

Housing Requirements

As a 523 grantee, you will be submitting your house plans as part of your 523 grant application, so most of these requirements should have already been considered at that time. Rural Development 502 Direct is designed to assist low- and very low-income households in the purchase of modest housing. Rural Development has few limitations on the specific aspects of a home, using a broad definition of modest relating to the square footage and overall value of the home/area loan limit. The prohibition to income producing property applies to the home as well as to the land, however home-based operations such as childcare, product sales, or craft production that do not require specific commercial real estate features are not restricted.

Square Footage Requirements – Rural Development has a minimum of 400 sq. ft. and a maximum of 2,000. Only habitable floor space that is entirely above grade is considered in these minimum and maximum limits. For example, a house with a first floor of 1,500 sq. ft. and a 1,500 sq. ft. basement with portions above grade, is only considered a 1,500 sq. ft. home. Garages attached or detached are not included in the square foot calculations for Rural Development's minimum and maximum. The 2,000 sq. ft. maximum can be waived by Rural Development but requires the loan approval official's next-level supervisor. These exceptions will be considered based on:

- The subject property is modest.
- The property is typical for the area and/or the applicant has special needs due to an exceptionally large household or a household member with a disability.
- The property's anticipated utilities and maintenance costs are reasonable for the area and will not place a strain on the applicant's budget.

Exceptions on the minimum square foot requirement may be waived by the loan approval official's next-level supervisor when the Field Office determines a smaller dwelling or "tiny home" otherwise meets the same property standards as other Agency financed dwellings.

Area Loan Limit

The area loan limit is the maximum value of the property established by Rural Development for each county. Although this is called the "loan Limit" it is referring to the maximum value, as established by appraisals. For self-help new construction, this means the cost of the land, materials, grants, loans and the value of sweat equity cannot exceed the area loan limit, but also the appraised value cannot exceed the area loan limit. There are four items that can exceed the area loan limit and appraised amount, these are: Rural Development tax service fee, initial escrow deposit and homeowner education fee. The actual loan limit/maximum loan amount for each applicant is based on the lesser of: 1) area loan limit, 2) appraised value, 3) actual amount needed to finance the home, and 4) amount the applicant can afford.

Example 1: The O'Donnell family is building their home through the 523 Mutual Self-Help Program. The area loan limit is $250,000 and the appraised value for their home is also $250,000. The actual cost to build the home is $150,000, plus the $75,000 lot, totaling $225,000. The O'Donnell family is also receiving a SHOP loan for $10,000, which means they only need a 502 loan of $215,000. When completing the 4-A calculator it shows that they would qualify for $245,000. Although the area loan limit and the appraisal and the amount they qualify for is higher, your maximum loan amount is the lessor of the four variables, which in this situation is the amount needed to construct the home minus other funding. The value of sweat equity is not based on the number of hours contributed or work accomplished, but on the difference between the appraised value and the actual cost. In this example the sweat equity is $25,000, which is $250,000 (appraisal) minus $225,000 (actual cost).

Example 2: The Washington family is also building their home through the 523 Mutual Self- Help Program and their area loan limit is $175,000 and the appraised value is $150,000. The actual cost is $140,000 ($115,000 construction and $25,000 land). Using the 4-A calculator they qualify for only $115,000. Since the actual cost is $140,000, they either need to choose a different, less expensive house plan and/or lot or they need additional grant resources to be provided. If the Washington family qualified for a $25,000 down payment assistance grant, they would be able to continue with the program using the same plans and lot. The maximum loan amount in this situation was $115,000 (4-A qualification amount), which was the lessor of the four variables, because the appraisal, area loan limit and actual cost were all higher. The Washington family will have sweat equity of $10,000, which is the difference between the appraised value ($150,000) and the actual cost ($140,000).

The area loan limits can be found on Rural Development's website and are updated annually. There are a few exceptions to the area loan limit, both for counties' overall limits and individual sites, however these each need additional time for Rural Development's approval and should be requested as early in the process as possible. Below are the two exceptions, which can be found in RD HB 1-3550 in Chapter Five.

1. Exceptions for Counties - States are not authorized to alter their limits throughout the year without prior approval from the Deputy Administrator, Single Family Housing. State Directors who have counties they believe merit loan limits exceeding the standard, may submit a request to the National Office by completing Form RD 2006-3, "Instruction and Form Justification." The request should be accompanied by a narrative and supporting data. The analysis should include local values for both existing homes in program-acceptable condition and the total costs to acquire or construct new dwellings. If you believe your county should receive an exception, this request should be made far in advance of application submission, considering it needs the Deputy Administrator's approval.

2. Exceptions for Individuals - The established area loan limits may be granted to accommodate the specific needs of an applicant, for example, to serve exceptionally large households or to provide reasonable accommodation for a household member with a disability. Requests for exceptions may be approved by the State Director if the cost of the property will exceed the limit by $5,000 or less. To request an exception, you need to include this request in your loan narrative with documentation on the need for the exception. For accommodations for household members with disabilities, you will need to provide the cost of accommodations that demonstrates that these costs cannot be

accommodated within the area's modest housing limit. The Rural Development Loan Originator will review your request and if in agreement, request an exception from the State Director.

Appraisals

The appraisal will be ordered by Rural Development as one of the final steps in the underwriting process. As loan packagers you will need to provide the following to Rural Development, which they will then provide to the appraiser.

(1) A copy of the fully executed option or sales agreement between the applicant and seller, with a legal description of the property

(2) Certified building plans and Description of Materials, and repair estimates, if applicable

(3) Existing surveys

(4) A copy of the existing title

(5) Tax bills or assessments

Environmental Review Requirements

USDA Rural Development requires Environmental Reviews (ER) for housing projects prior to approving financial assistance. The ER must be done in accordance 7 CFR Part 1970 which includes compliance requirements for the National Environmental Policy Act (NEPA), a law that supports efforts to stimulate the health and welfare of humankind while safeguarding their environment. This must be completed prior to obligation of RD funds and is often completed prior to 502 application processing as part of the land development, however you should ensure its completion as the process includes required timeframes and can prevent loans from being obligated and delay closing. The environmental review process is separate from the review for other funding sources, such as HUD, however Rural Development can use their gathered information and approval to expedite their process.

The level of review depends on the type of project. NEPA's three classes of action include:

• Categorical Exclusion—for projects with less than five homes that do not have any impacts on environmental resources (RD Instruction 1940.310). The review, Form RD 1940-22, is completed by Rural Development staff.

• Environmental Assessment—for projects that have a higher potential for impact on the environment (subdivisions). The State Historic Preservation Officer (SHPO) should be notified of the proposed project (RD Instruction 1940.311). The request for information, Form RD 1940-20, should be completed by grantee.

• Environmental Impact Statement (EIS)—for projects or proposals that will have a significant impact on the quality of the environment. Not applicable to most housing projects (RD Instruction 1940.313).

It is the grantee's responsibility to provide the necessary information to Rural Development to determine what type of review is required, which will also assist them to complete their review. Rural Development can guide you through the process.

Flood Plain and Flood Insurance Requirements

Property that FEMA has identified as being in a Special Flood Hazard Area (SFHA) must have the availability of flood insurance through FEMA's National Flood Insurance Program. Flood insurance is required for all property located within the 100-year flood plain unless FEMA has granted an exception and flood insurance is available as part of the community's flood plain management regulations.

Properties located within the 100-year flood plain must be either:

- Served by public utilities located and constructed to minimize or eliminate flood damage, or
- Have on-site water and waste disposal systems located and constructed to avoid contamination of the water supply by the septic system due to flooding

New construction and substantially rehabilitated dwellings must be constructed so that the lowest floor (including the basement) is elevated to or above the 100-year flood level. Also, the materials and methods used must be for the purpose of making the dwelling resistant to flood damage and minimizing flood damage that may occur.

502 and Self-Help Insurance Requirements

During the application process is it important to explain to applicants the insurance requirements and estimated costs for both the construction phase and homeowners' insurance for the life of the loan. The applicants will need to shop around for insurance to compare pricing and coverage. You will need to provide information on each type and encourage applicants to shop for the best option for their needs, especially for their homeowners' policy. Rural Development requires that the insurance covers the dwelling and any other essential buildings (such as a garage) in an amount that is equal to the insurable value (i.e. the cost to restore the property back to its state prior to a loss) of the dwelling and other essential buildings, or the unpaid principal balance.

Builder's risk or course of construction insurance - The homeowner (self-help participant) obtains insurance for the house during the time that is being constructed. The policy covers the structure and materials, excluding land value. Generally, it covers damage from fire, theft, vandalism, and other. Some exclusions include earthquake, water damage and professional liability. It is important to be familiar with terms, limitations and exclusions.

Homeowners insurance - As soon as the home is completed, and as required by the lender, the homeowner (self-help participant) obtains a standard policy that covers two areas: property and liability. Generally, it covers damage from fire, theft, vandalism, and other. Some exclusions include earthquake and flood. It is important to be familiar with its terms, limitations and exclusions and RD's HB-1-3550, Attachment 7-C details Rural Development's property insurance requirements, which can be found as Appendix 8 at the end of this guide.

502 Property Submission Documents

House Plans and Description of Materials

New homes should be built according to approved house plans and description of materials/specifications, and applicable building codes. Form RD 1924.2, Description of Materials, should be completed for each home by the grantee. This form can be found as Appendix 12 of this guide. The description of materials must be based on the certified house plans, which are also submitted at this stage of the loan application.

Cost Estimates

Grantees submit cost estimates for each of their house plans as part of the Section 523 Technical Assistance Grant Application. These figures continually change based on the cost of materials, which can be impacted by numerous market forces including natural disasters. Sub-contractors' bids are also impacted by material costs and the demand of their services. You will have included an estimated cost based on your past builds and projected increases as part of the borrower eligibility packet, however it is crucial that all of the expenses included in your cost estimate are reviewed and revised based on your current market as part of the completion of the cost estimates included in the property document submission. The cost estimate included in the property submission at this time will be what the loan amount is based on.

Inspections and Requirements during Construction

All new construction is required to be inspected by an approved inspector at a minimum at the footer, frame-in and final stages of construction. Rural Development typically accepts the local building officials' inspection reports. However, in areas where there are none Rural Development will inspect and/or will accept a qualified third-party individual's report. Rural Development also requires all homes to be built to local codes, obtain required local permits and pass all local building inspections, which may include more than the required footer, frame-in and final inspections. Grantees will provide construction costs, certifications, inspection reports and suppliers and subcontractors' warranties to Rural Development as they are received during the construction process.

Homes Constructed Under Specific Energy Efficiency Programs

A new home built to exceed the prevailing International Energy Conservation Code is more energy efficient, which significantly lowers the homeowner's utility costs. The lower utility costs associated with these energy efficient homes indicate that a prospective borrower may be able to make larger loan payments than the ratio analysis suggests. Given their resulting energy efficiency savings of up to 30 percent relative to typical new homes, as well as their progressive and routinely updated building standards, new homes constructed under the approved Rural Development national programs may be considered as a compensating factor (when approved by the next level supervisor). A list of these programs can be found in HB-1-3550 Chapter 4, under Compensating Factors. You should discuss with your Rural Development loan approval official the appropriate documentation needed to verify that the home will meet this standard, if you are requesting an increase in ratios based on this compensating factor. Since this request is part of the initial eligibility determination, this should already be approved, and the needed initial documentation provided with property submission.

Self-Help Home Rehabilitation

The 523 Self-Help Housing Program includes housing rehabilitation as an eligible program design, which includes acquisition/rehab/resale, acquisition and rehabilitation and owner-occupied rehab. Acquisition/rehab/resale is when the grantee purchases the home and then the construction supervisor provides training and coordination with the Rural Development approved applicant to rehab the home prior to their purchase. Acquisition and rehabilitation is another popular approach, when the applicant purchases the home prior to rehab and then the 502 loan covers the cost of the home and the required repairs. The construction supervisor works with the owner builder to provide training and coordination for the required repairs. With this approach the owner builder does not move in until the Certificate of Occupancy is issued and Rural Development final inspection is completed. The owner-occupied rehabilitation approach is for existing homeowners that need repairs to make their home safe, decent and sanitary. Often these homeowners receive a 504 loan and/or grant to cover the cost of materials and skilled labor. The construction supervisor works with the owner to provide training and coordination for the required repairs. Although owner occupied applicants typically receive 504 loans and/or grants, a 502 loan may be a better option if the applicant needs a larger amount to cover the needed repairs. If they currently have a mortgage and the payment for the 502 repair loan (of more than $5,000) and their existing loan payment are not affordable, Rural Development could refinance the first mortgage along with the repair amount if this will make it affordable to the applicant and they meet all other eligibility requirements.

The required documentation needed at this stage of application differs slightly and includes:

- Work write up/scope of work
- Cost estimate
- Whole home inspection by a state licensed whole home inspector, which includes at a minimum inspection of: 1) termites and other pests (this may be separate from the

whole house inspection) 2) plumbing, water and sewage 3) heating and cooling 4) electrical systems, and 5) structural soundness.

These projects will also have to comply with all applicable local building codes and permits relating to housing rehab and their corresponding inspections.

CHAPTER 9

LOAN CLOSING AND CONVERSION

Steps for the Packager

1. Updated eligibility and income for loan closing, if necessary
2. Loan closing with the title company/closing attorney
3. Updated income verifications for conversion
4. Conversion

In the self-help program the loan closing actually takes place before any work on the home has begun, this is what makes the program participants true owner builders. Conversion takes place after all construction and applicable paperwork is completed.

Loan Closing

Once your 502 application has been approved and appraisals are received, in coordination with Rural Development and the title company/loan attorney, the applicant is ready to close their loan. This means executing the loan documents and transferring the funds, including any initial draws for land, permits, materials, etc. This loan will act as a construction loan throughout the building process. It is generally not necessary that the packager attend the closing as the closing agent will walk the applicant through the process. However, if your organization is selling the land/home to the borrower, there will be documents that need to be signed prior to the closing.

In preparation for closing, you may be asked to assist Rural Development to gather updated verifications if the ones used to determine eligibility are more than 180 days old. This requires verification of eligibility information and income in the same way it was done for the

Certificate of Eligibility (COE), based on the preferred sources. Usually you'll be asked to gather updated paystubs, award letters, etc. (see Verifications in Chapter 7 of this guide) but Rural Development carries most of the weight here and oversees and completes all of the closing documents.

Documents you will assist with gathering for loan closing:

- ✓ Updated eligibility information and verifications
- ✓ Insurance binder (see Chapter 8 of this guide)

Tracking documents through closing

It is good to track the dates of the verification documents throughout the application and closing process so you can anticipate documents that are going to expire prior to closing. This way, you can gather them prior to RD's request to ensure there is no delay.

Section 502 Draws

Once the 502 loan is closed and drawdowns are needed from a participant's loan account, significant planning is required by the grantee to determine the amount to be requested. This is because once you start drawing on the 502 account, the borrower begins accruing interest on the amount drawn. If you overestimate or over draw, the borrower is potentially paying more in interest than they would need to when draws are well planned. On the other hand, if you don't draw enough, you won't have the funds the participant needs when invoices become due.

Section 502 funds are advanced from NFAOC in St. Louis and disbursed by the local offices based on regulatory guidelines. Grantees prepare the draw-downs and checks for each participant's account as needed to purchase materials for different phases of construction. The participant's loan payments are deferred during construction and the entire amount of the loan can be drawn down prior to completion of the home.

There are historically two methods for accounting and drawing 502 funds during construction, Supervised Bank Accounts (SBA) and Custodial Style Bill Paying, there is much more detail on this in the *Individual Borrower 502 Loan Accounts Guidebook*.

Conversion

The construction loan is converted for amortized payments which will be due the first day of the month as a permanent loan in MortgageServ once the final disbursement is posted and following **any** of these events:

- Final inspection by the Agency or qualified third party;

• Issuance of the Certificate of Occupancy by the local jurisdiction;
• Occupancy of the new or repaired dwelling

Loan conversion and the final inspection can occur on the same day provided the local office receives a copy of the final occupancy permit or other equivalent inspection report(s). The final inspection will often be completed by a local building official (especially if it's required for the Certificate of Occupancy) and also on occasion, by Rural Development. While Rural Development is not required to conduct this final inspection, some offices still choose to do it. It usually takes a little while after the inspections and the homes are complete to get final invoices, the bank accounts closed, paperwork completed by Rural Development to prepare for the conversion and then the conversion itself must actually take place on the first of the month.

A (construction) loan is converted to a permanent loan when:

- ✓ The home is completed to the plans and specs and description of materials
- ✓ The Certificate of Occupancy is issued
- ✓ Following the Rural Development final inspection, if the local office chooses to do one
- ✓ All funds are distributed to cover costs incurred
- ✓ The grantee has approved the participants to move in

At conversion, Rural Development will often ask the grantee to help to gather some updated information to help them analyze the borrowers need for payment subsidy. This requires verification of income information in the same way it was done for the COE and loan closing, based on the preferred sources. Usually you'll be asked to gather updated paystubs, award letters, etc. (see Verifications in Chapter 7 of this guide). This income verification is for the purposes of payment subsidy, and not to re-determine eligibility. Eligibility has already been determined and cannot be taken away, even if the applicant's income has increased and they are now over the limits, unemployed, etc. The borrower's monthly mortgage payment will likely change from the original projection at this point though. This may be because their income has changed and their subsidy changes as it is based on their current income and reviewed and revised annually. It may be a small or a large difference. Another reason is that their total loan amount has increased through the build process as interest has accrued on their construction draws. The loan documents will be revised, with the new total loan amount, including accrued interest at the time of conversion.

Conversion itself will take place on the first of the month and the first payment will be due on the first of the month following conversion. For example, the participants move in on January 15th, the conversion takes place on February 1st and homeowner's first payment will be due on March 1st. When conversion is complete, NFAOC takes over servicing responsibilities, receiving and processing monthly payments, issuing late notices, recertification's, etc.

> Do not sign USDA Form RD 1924-19, Builder's Warranty. This is for contractor-built homes, not self-help.

Funds Remaining After Conversion

During conversion any remaining 502 loan funds in the borrowers account are moved from the grantee's account to Rural Development. Your responsibility has been to build the homes to the plans and description of materials. Once this is done and the funds have been moved, your responsibility for the funds have ended at this point. Any use of those funds (for authorized purposes approved by Rural Development) is between Rural Development and the homeowner. Many grantees put in their group agreement that any remaining funds will be put towards the loan to avoid problems after the homes are complete.

You don't want there to be any confusion about work that you are responsible for overseeing and work that was outside your scope (not on the plans or in the description of materials). For example, you authorize a participant to add a deck with remaining loan funds and it is faulty, so Rural Development comes back to you for warranty information and you don't have any. Or the whole group decides they want to put in fences and buy all the materials, but only half of them actually put up the fences and the others have materials lying on the ground going bad, now Rural Development would like to know what you're going to do.

CHAPTER 10

BRINGING IT ALTOGETHER AND BUILDING A PROGRAM

Steps in Building a SH Group

1. Secure building site
2. Outreach & recruitment
3. Application intake and housing/credit counseling
4. Develop a waiting list of applicants
5. Complete borrower eligibility application submission (all group participants)
6. Receive Certificates of Eligibility (all group participants)
7. Pre-construction meetings start (consider the best timing for your program)
8. Complete property application submission (all group participants)
9. Continue pre-construction meetings
10. Loan closing
11. Construction start

Packaging for self-help 502 applicants includes additional considerations to ensure they meet the needs of the self-help program. Unlike packaging for individual applicants, the challenges of submitting a group of applicants who can all close and start on their homes at the same time requires significant coordination. Your organization will need to coordinate internally on the securing the property, construction documents, outreach and the 502 application submissions to meet the 523 Implementation Plan and grant goals. You do not want to rush the application process to meet your organization's needs, which can result in unprepared, frustrated and possibly unsuccessful owner builders. Frustration can occur early in the process between the 523 grantee and the owner builder when applications are rushed, that later impacts the overall build group. A successful owner builder is not only a family who qualifies for the loan and completes the home, but one who is a successful homeowner for the long-term. This chapter is designed to emphasize the timing and steps needed for a successful 523 program and your role in 502 loan packaging. Other Self-Help Guides provide further details on these topics including: Program Director Handbook, Group Coordinator Training Handbook, Pre-Construction Meeting Guide and Construction Supervisors Handbook.

Outreach & Recruitment

As a 523 grantee your outreach and recruitment will need to take into consideration the area of your next build group(s). This is to ensure that you have enough qualified applicants interested in building their homes at that location to meet your implementation goals. For many 523 grantees, your service area can be very large covering more than one county and possibly hundreds of miles. Your Affirmative Fair Housing Marketing Plan will be targeted toward those who might be interested in living in the location of the identified build site. For additional information on marketing and outreach, including information on Fair Housing and the Affirmative Fair Housing Marketing Plan refer to the Group Coordinator Handbook. This plan should be implemented at least a full year prior to your anticipated start date for applications as it can take a while to get enough applicants, especially if it is a new area for your self-help program. If it is a new area, you may want to start your outreach, marketing and recruitment two years prior to the projected build, to allow applicants to resolve credit or other eligibility concerns and still participate. This is especially true if you are not planning on another build group in the area in the near future, for which they could qualify if they need additional time.

Timing Needed for Qualifying a Full Build Group

It is rare that an applicant meets all of the eligibility requirements the day they complete the initial intake form. Often there is a need to resolve credit concerns, gather all of the required documentation and to decide if the 523 program is the best fit for their family. Because every applicant has different needs and questions, it can be a challenge to have a full build group ready at one time. Do not under estimate the amount of time it will take, because if you do it can delay your overall program implementation by delaying the start of the build. Ideally you have created a waiting list of applicants, which is an ongoing and open application process. You should also have an established housing counseling program or partnership with another agency to assist applicants who do not initially qualify based on credit requirements. If you do not have an established waiting list, you should anticipate at least a 12-month application processing time for groups with more than six owner builders. This time frame is in addition to your outreach and recruiting. Keep in mind that you will need to maintain current income, asset and credit information. So if the applications are taking longer than three months to complete, you will likely need to update these third-party verifications either prior to submission and/or prior to closing (income documents expire after 180 days for construction/permanent loans).

When you cover a large geographic area and you have several years between build groups, it is challenging to keep people on a waiting list and maintain their interest in waiting several years for the next build. If this is the case, you might want to consider becoming a 502 Certified Packager, allowing you to submit those applicants who are not ready for the 523 build to still receive a 502 Direct Loan that would allow them to purchase an existing home in that area. If you are not a 502 Certified Packager, you can still refer these applicants directly to Rural Development for a purchase of a non-self-help home. Make sure you thoroughly consider the timing when referring an applicant to purchase on the market with a 502 Direct Loan verses your next 523 build. It can take a year to create a build group of qualified applicants, with applicants meeting the eligibility requirements at different times. You do not want to create unnecessary competition for your 523 program by referring applicants to existing homes on the market. However, if you do not foresee building again in that area for more than two years, loan packaging or a referral to Rural Development for an existing home with a 502 Direct Loan might be a way for the applicant to become a homeowner and your work to not be in vain.

Application Submission

The program is designed for all applications in a building group to be submitted, reviewed and closed at the same time, however some Rural Development loan approval officials prefer a staggered submission. Rural Development has 30 days to review your application and determine eligibility, so staggering application submissions can be an advantage for you and Rural Development. However, many Rural Development offices prefer, and some require, all applications to be submitted together before they will start their review. This ensures them that you have a full build group and prevents them from doing multiple reviews if the final application submissions were delayed and documents expire. You should discuss this with your local Rural Development office to determine which they prefer, complete or staggered submissions. There are a couple of process steps that ideally should be done together, these include request for appraisals, loan obligation and loan closings. So, even if you do decide on a staggered submission, it is best if all applications can be submitted within a couple of weeks and generally not longer that a month between the first and last application.

The other submission question is whether you submit the full application, which includes all of the property documents, or just the borrower eligibility. The challenge for Rural Development with a full application submission is that it triggers TRID (TILA RESPA Integrated Disclosures) requirements, which requires the full review of all of the group's applications within the three-day TRID disclosure requirements. Because of these requirements, Rural Development typically prefers to have the borrower eligibility submission be first and then the property submission after they have determined eligibility and issued the Certificate of Eligibility. Although you submitted the loan application (RD Form 410-4) as part of the borrower eligibility submission, it isn't complete until the property section is complete, which then triggers the TRID requirements. Submitting the application in two sections allows Rural Development time to complete the borrower eligibility, which is the most time intensive and then the property section, which has fewer review components to complete the TRID disclosures. A two-step process also allows you more time to complete the property portion and prevents you from completing this information for an applicant who isn't determined eligible. It also allows you the time to review and update your cost estimates to reflect the current market.

Pre-Construction Group Meetings

There is an entire Self-Help Handbook, *Pre-Construction Meeting Guide,* which is recommended if you are a new grantee, new in your position or a great refresher to brush up on ideas for these meetings. You may not be responsible for these meetings, but it is important to understand what is covered and how the timing of these correlates with the 502 packaging process. These meetings typically include information that relates to homebuyer education and housing counseling, although it typically does not meet Rural Development's requirement for homebuyer education. Pre-construction meetings also typically include information on choices that are later included in the property documents submitted to Rural Development. There are numerous variations on the content and timing of these meetings, but the overall goal is to provide information and to build the owner builders into a group that will be key to the successful completion of their homes. Once again, they should not be rushed to meet your goals, as this can result in less informed and frustrated owner builders. The timing and content of these meetings should be discussed internally considering all of the components of the 523 program and the overall goal of a successful group build.

Conversion

The last step of the process for the 502 loan is the conversion from a construction loan to a permanent loan. Loan conversion details are discussed in Chapter 9 of this guide. Make sure you factor this step into your overall timing and work plan. New third-party verifications will likely be required, and these can take time to gather. Make sure you are requesting the needed documents at least a month in advance of your projected conversion date, so that conversion is not held up for everyone or because one or more owner builders did not have enough time in the midst of completing their homes to provide you the needed documentation.

Ongoing Communication and Documentation

Packaging 502 loans for self-help is a long-term process, from initial intake to loan conversation. It is important to keep a running record of your communication and to have complete and ordered files throughout the process. These files will be reviewed by funders and your T&MA contractor and used to answer questions years later. It is your job to make sure they are complete, accurate, accessible and orderly, so that anyone can easily find the needed information.

Appendices

Appendix 1: Application Processing Checklist

Appendix 2: Exhibit 4-3, Types of Assets

Appendix 3: Exhibit 4-4, Indicators of Unacceptable Credit

Appendix 4: RD Form 1944-60, Landlord's Verification

Appendix 5: Form RD 1-3550, Authorization to Release Information

Appendix 6: Form RD 1944-61, Credit History Worksheet

Appendix 7: Attachment 3-J, Checklist of items to accompany the Uniform Residential Loan Application

Appendix 8: HB-1-3550, Attachment 7-C, Insurance Policy Requirements

Appendix 9: Handbook Letter 16 (3550), Eligibility of Self- Help Applicants

Appendix 10: Uniform Residential Loan Application, Form RD 410-4

Appendix 11: Form RD 1-35502 Subsidy Repayment Agreement

Appendix 12: Form RD 1924-2, Description of Materials